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Property and liability insurance entities with conforming changes as of June 1, 2010; Audit and accounting guide

American Institute of Certified Public Accountants. Property and Liability Insurance Companies Task Force

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Audit & Accounting Guide: Property and Liability Insurance Entities

June 1, 2010

AICPA®

AUDIT & ACCOUNTING GUIDE

Property and Liability Insurance Entities

JUNE 1, 2010

AICPA®

AUDIT & ACCOUNTING GUIDE

Property and Liability Insurance Entities

With conforming changes as of

June 1, 2010

This edition of the AICPA Audit and Accounting Guide *Property and Liability Insurance Entities*, which was originally issued in 1990, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The schedule of changes identifies all changes made in this edition of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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Preface

About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been prepared to assist property and liability insurance entities in preparing financial statements in conformity with generally accepted accounting principles (U.S. GAAP) and statutory accounting principles (SAPs) and to assist independent auditors in auditing and reporting on those financial statements.

The financial accounting and reporting guidance contained in this guide has been approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, now the Financial Reporting Executive Committee (FinREC), which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming updates made to the financial accounting and reporting guidance contained in this guide in years subsequent to the original development are reviewed by select FinREC members, among other reviewers where applicable.

This guide does the following:

- Identifies certain requirements set forth in Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC) [*or, if applicable, add or replace with "GAAP for governmental entities"*]
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed subsequently in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category *b* of the hierarchy of GAAP for state and local governmental entities, and has been cleared by the Governmental Accounting Standards Board (GASB). AICPA members should be prepared to justify departures from generally accepted accounting principles as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU section 150, *Generally*

Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

Recognition

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Accounting Standards Executive Committee

Darrel R. Schubert *Chair,*
Auditing Standards Board

Insurance Companies Committee (1988–1989)

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Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued. Authoritative guidance issued through June 1, 2010, has been considered in the development of this edition of the guide. This includes relevant guidance issued up to and including the following:

- FASB Accounting Standards Update (ASU) No. 2010-15, *Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
- SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801)
- Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .93–.97)
- Revised interpretations issued through May 1, 2010, including Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.08)
- Statement of Position 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data* (AICPA, *Technical Practice Aids*, AUD sec. 14,440)
- Statement on Standards for Attestation Engagements No. 15, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1, AT sec. 501)
- Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101 par. .59–.69)
- Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2)
- Interpretation No. 31, "Preparation of Financial Statements for Use by an Entity's Auditors," of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .136–.137)
- Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the schedule of changes in appendix I. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

References to Professional Standards

In citing the professional standards, references are made to AICPA *Professional Standards*. In those sections of the guide that refer to specific auditing standards of the PCAOB, references are to the AICPA's *PCAOB Standards and Related Rules* publication. When referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1).

FASB *Accounting Standards Codification*™

Overview

Released on July 1, 2009, FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force [EITF], and the AICPA) to organize them under approximately 90 topics.

FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View.

FASB Statement No. 168

In June 2009, FASB issued the last FASB Statement referenced in that form: FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*. This standard establishes FASB ASC as the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC, and is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

This standard flattened the historic U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992.

Issuance of New Standards

New standards are now issued by FASB through ASUs and will serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; new standards become authoritative when they are incorporated into FASB ASC.

New standards will be in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2010-01 is the first update in the calendar year 2010. New standards will include the standard and an appendix of FASB ASC update instructions. ASUs will also provide background information about the standards and provide the basis for conclusions on changes made to FASB ASC.

Pending Content in FASB ASC

Any ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) issued but not yet fully effective for all entities or transactions within its scope are reflected as "Pending Content" in FASB ASC. This pending content is shown in text boxes below the paragraphs being amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph becomes fully effective, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

Because not all entities have the same fiscal year-ends, and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the "roll off" date. Generally, the *roll-off* date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2009. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2009, and end November 14, 2010. Accordingly, the roll-off date would be April 14, 2011.

Entities cannot disregard the pending content boxes. Instead, all entities must review the transition guidance to determine if and when the pending content is applicable to them. This audit and accounting guide identifies pending content where applicable.

Select Recent Developments Significant to This Guide

Withdrawal of GAAP Hierarchies From the Auditing Standards

In response to the issuance of recent pronouncements by FASB, GASB, and the Federal Accounting Standards Advisory Board to incorporate their respective GAAP hierarchies into their respective authoritative literature, the ASB has withdrawn SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*, from the auditing literature effective September 2009. Similarly, with the release of PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), and conforming amendments in January 2008, the PCAOB also removed the GAAP hierarchy from its interim auditing standards applicable to issuers.

ASB's Clarity Project

In an effort to make generally accepted auditing standards (GAAS) easier to read, understand, and apply, the ASB launched the Clarity Project. When completed, clarified auditing standards will be issued as one SAS that will supersede all prior SASs. The new audit standards are expected to apply to audits of financial statements for periods ending on or after December 15, 2012.

The foundation of the ASB's Clarity Project is the establishment of an objective for each auditing standard. These objectives will better reflect a principles-based approach to standard-setting. In addition to having objectives, the clarified standards will reflect new drafting conventions that include

- adding a definitions section, if relevant, in each standard.
- separating requirements from application and other explanatory material.
- numbering application and other explanatory material paragraphs using an *A* prefix and presenting them in a separate section (following the requirements section).
- using formatting techniques, such as bulleted lists, to enhance readability.
- adding special considerations relevant to audits of smaller, less complex entities.
- adding special considerations relevant to audits of governmental audits.

The project also has an international convergence component. The ASB expects that, upon completion of the project, nearly all the requirements of ISAs will also be requirements of U.S. GAAS. AICPA Audit and Accounting Guides, as well as other AICPA publications, will be conformed to reflect the new standards resulting from the Clarity Project after issuance and as appropriate based on the effective dates.

International Financial Reporting Standards

International Financial Reporting Standards (IFRSs) consist of accounting standards and interpretations developed and issued by the International Accounting Standards Board (IASB), a London-based independent accounting standard-setting body. IASB began operations in 2001, when it succeeded the

International Accounting Standards Committee (IASC). IASC was formed in 1973, soon after the formation of FASB. In 2001, when the IASB replaced the IASC, a new, independent oversight body, the IASC Foundation, was created to appoint the members of the IASB and oversee its due process. The IASC Foundation's oversight role is very similar to that of the Financial Accounting Foundation in its capacity as the oversight body of FASB.

The term *IFRSs* has both a narrow and a broad meaning. Narrowly, IFRSs refer to the new numbered series of pronouncements issued by the IASB, as differentiated from International Accounting Standards (IASs) issued by its predecessor, the IASC. More broadly, however, IFRSs refer to the entire body of authoritative IASB pronouncements, including those issued by the IASC and their respective interpretive bodies. Therefore, the authoritative IFRS literature, in its broadest sense, includes the following:

- Standards, whether labeled IFRSs or IASs
- Interpretations, whether labeled IFRIC (referring to the International Financial Reporting Interpretations Committee, the current interpretive body of the IASC Foundation) or SIC (Standing Interpretations Committee, the predecessor to IFRIC and former interpretive body of the IASC)
- IFRS framework

The preface to the IFRS 2009 bound volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities including commercial, industrial, and financial entities regardless of legal form or organization. Included within the scope of profit-oriented entities are mutual insurance companies and other mutual cooperative entities providing dividends or other economic benefits to their owners, members, or participants.

IFRSs are not designed to apply to not-for-profit entities or those in the public sector, but these entities may find IFRSs appropriate in accounting for their activities. In contrast, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The AICPA governing council voted in May 2008 to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203 of the AICPA's Code of Professional Conduct gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As a result, private entities in the U.S. can prepare their financial statements in accordance with U.S. GAAP as promulgated by FASB; an other comprehensive basis of accounting, such as cash- or tax-basis; or IFRSs, among others. However, domestic issuers are currently required to follow U.S. GAAP and rules and regulations of the SEC. In contrast, foreign private issuers may present their financial statements in accordance with IFRSs as issued by the IASB without a reconciliation to U.S. GAAP, or in accordance with non-IFRS home-country GAAP reconciled to U.S. GAAP as permitted by Form 20-F.

The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years. See appendix H, "International Financial Reporting Standards," for a discerning look at the status of convergence with IFRSs in the U.S. and the important issues that accounting professionals need to consider now.

Insurance Contracts Project

The IASB split their insurance contract project into two phases so that some components of the project were completed by 2005 without delaying the rest of the project. Phase I addresses the application of existing IFRSs to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts. The issuance of IFRS No. 4, *Insurance Contracts*, along with *Basis for Conclusions on IFRS 4* and *Implementation Guidance to IFRS 4* brought to a close phase I of the international insurance project.

Effective for the aforementioned international insurers for annual periods beginning on or after January 1, 2005, IFRS No. 4 provides the framework for accounting for insurance contracts until the IASB completes Phase II. IFRS No. 4 generally allows insurance contracts to be accounted for under the insurer's existing local accounting with some enhancements to those local standards. Although IFRS No. 4 permits the continuation of the existing local accounting for insurance contracts, the standard has imposed a requirement that the contract must contain significant insurance risk to qualify as an insurance contract under IFRS No. 4. The standard applies to reinsurance contracts as well as insurance contracts. IFRS No. 4 does not apply to other assets and liabilities of an insurer. Readers with international reporting situations should continue to be alert to potential developments in international accounting standards for insurance contracts.

In August 2007, FASB issued an invitation to comment, *An FASB Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper,* Preliminary Views on Insurance Contracts. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project. The boards are planning to release an exposure draft in the second quarter 2010. For more specific information, visit the FASB website at www.fasb.org and the IASB website at www.iasb.org.

Limitations

This guide does not discuss the application of all U.S. GAAP, all GAAS nor all PCAOB auditing standards that are relevant to the preparation and audit of financial statements of property and liability insurance entities. This guide is directed primarily to those aspects of the preparation and audit of property and liability insurance entities' financial statements that are unique to those organizations or are considered particularly significant to them.

Introduction

This guide describes operating conditions and auditing procedures unique to the insurance industry and illustrates the form and content of financial statements and disclosures for property and liability insurance companies, various pools, syndicates, and other organizations such as public entity risk pools. Chapter 1, "Nature, Conduct, and Regulation of the Business," discusses the nature, conduct, and regulation of the insurance industry. Among the other significant areas discussed in this guide are

- audit considerations, including a discussion of the auditor's risk assessment process.
- the premium cycle, including a discussion of rating, transactions, accounting practices, and special risk considerations.
- the claims cycle, including a discussion of accounting practices and special risk considerations.
- the investment cycle, including a discussion of regulation, various investment alternatives, accounting practices, and special risk considerations.
- reinsurance, including a discussion of the kinds of reinsurance, accounting practices, ceded reinsurance, and assumed reinsurance.
- taxes, including both federal and state.
- differences between SAP and GAAP.

In addition, appendix B discusses control activities and auditing objectives and procedures.

Discussions of accounting in this guide are generally intended to refer to authoritative literature. Discussions of SAP are mentioned if they differ from GAAP. Some significant differences between GAAP and SAP are discussed also in chapter 1.

Public entity risk pools are required to follow the accounting and financial reporting requirements of GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended and interpreted by various GASB pronouncements.[1] That statement is based primarily on FASB ASC 944, *Financial Services—Insurance*, and related pronouncements but includes certain accounting and financial reporting requirements that differ from FASB ASC 944. As discussed in chapter 1, many public entity risk pools are not subject to the same regulation as property and liability insurance companies.

The National Association of Insurance Commissioners (NAIC) continually monitors SAP for insurance companies. Through various committees, such as the NAIC Statutory Accounting Principles and Emerging Accounting Issues Working Group, recommendations are made to state insurance departments regarding changes in statutory accounting and reporting. The NAIC codified SAP for certain insurance enterprises resulting in an *Accounting Practices and Procedures Manual*. The insurance laws and regulations of the states require

[1] Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, provides guidance for the format and content of financial statements for all state and local governmental entities, including public entity risk pools.

insurance companies domiciled in those states to comply with the guidance provided in the manual except as prescribed or permitted by state law. All states require insurers to comply with most, if not all, provisions of the manual. States have adopted the manual in whole or in part as an element of prescribed SAP in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. The NAIC publication *States' Prescribed Differences from NAIC Statutory Accounting Practices* describes by state, the differences from the manual.

As issues are resolved, amendments to this guide may be issued by the AICPA, or pronouncements may be issued by FASB or GASB.

Effective Date

The auditing provisions of this guide are effective for audits of financial statements of property and liability insurance companies for periods beginning on or after December 15, 1990.

TABLE OF CONTENTS

Chapter 1

Nature, Conduct, and Regulation of the Business

General Nature of the Business

1.01 The primary purpose of the property and liability insurance business is the spreading of risks. The term *risk*[1] generally has two meanings in insurance. It can mean either a *peril insured against* (for example, fire is a risk to which most property is exposed) or a *person or property protected* (for example, a home or an automobile). For a payment known as a premium, insurance entities undertake to relieve the policyholder of all or part of a risk and to spread the total cost of similar risks among large groups of policyholders.

1.02 The functions of the property and liability insurance business include marketing, underwriting (that is, determining the acceptability of risks and the amount of the premiums), billing and collecting premiums, investing and managing assets, investigating and settling claims made under policies, and paying expenses associated with these functions.

1.03 In conducting its business, an insurance entity accumulates a significant amount of investable assets. In addition to funds raised as equity and funds retained as undistributed earnings, funds accumulate from premiums collected; from sums held for the payment of claims in the process of investigation, adjustment, or litigation; and from sums held for payment of future claims settlement expenses. The accumulation of these funds, their investment, and the generation of investment income are major activities of insurance entities.

Kinds of Insurance

1.04 Kinds of insurance, generally referred to as *lines of insurance*, represent the perils that are insured by property and liability insurance entities. Some of the more important lines of insurance are

- *fire and allied lines*, which include coverage for fire, windstorm, hail, and water damage (but not floods).
- *ocean marine*, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages.
- *inland marine*, which covers property being transported other than transocean. (It also includes floaters, which are policies that cover movable property, such as a tourist's personal property.)

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[1] This definition differs from the definition of *insurance risk* stated in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, which describes insurance risk as the risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured. It is the definition in the FASB ASC glossary that determines the proper accounting when considering risk transfer. See chapter 6, "Reinsurance."

- *workers' compensation*, which compensates employees for injuries or illness sustained in the course of their employment.
- *automobile*, which covers personal injury or automobile damage sustained by the insured and liability to third parties for losses caused by the insured.
- *multiple peril*, which is a package coverage including most property and liability coverage except workers' compensation, automobile insurance, and surety bonds.
- *professional liability*, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service.
- *miscellaneous liability*, which covers most other physical and property damages not included under workers' compensation, automobile liability, and multiple peril policies. Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property.
- *fidelity bonds*, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees.
- *surety bonds*, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits.)
- *accident and health*, which covers loss by sickness or accidental bodily injury. It also includes forms of insurance that provide lump-sum or periodic payments in the event of loss by sickness or accident, such as disability income insurance and accidental death and dismemberment insurance.

1.05 In addition to these lines, insurance is provided by excess and surplus lines. *Excess liability* covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. *Surplus lines* include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. These kinds of policies are generally written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

1.06 The lines and premium volume that may be written by an entity are generally restricted by state insurance regulations. States also use risk-based capital standards for regulating solvency and capacity and also monitor the amount of premium written as a ratio of the entity's surplus.

1.07 Insurance written by property and liability insurance entities may be broadly classified as *personal lines*, which consist of insurance policies issued to individuals, and *commercial lines*, which consist of policies issued to business enterprises. Personal lines generally consist of large numbers of relatively standard policies with relatively small premiums per policy. Examples are homeowner's and individual automobile policies. Commercial lines involve policies with relatively large premiums that are often retroactively adjusted based on claims experience. The initial premium is often only an estimate because it may be related to payroll or other variables. Examples are workers' compensation and general liability. Many large insurance entities have separate accounting, underwriting, and claim-processing procedures for these two categories.

1.08 Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established programs to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. Following are some of the more common programs that provide the necessary coverage:

- *Involuntary automobile insurance*. States have a variety of methods for apportioning involuntary automobile insurance. The most widely used approach is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all entities writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Each automobile insurer operating in the state accepts a share of the undesirable drivers, based on the percent of the state's total auto insurance that it writes. For example, an entity that writes 5 percent of the voluntary business in a state may be assigned five percent of the involuntary applicants. It is then responsible for collecting the premiums and paying the claims on the policies issued to these applicants. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing entities are designated to handle high-risk drivers. States may require insurers to participate in the underwriting results.

- *Fair Access to Insurance Requirements (FAIR) plans*. FAIR plans are state-supervised programs established to provide coverage for property in high-risk areas. Entities that operate in the state are required to participate in the premiums, losses, expenses, and other operations of the FAIR plan.

- *Medical malpractice pools*. These pools were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.

- *Workers' compensation pools*. These pools are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

Organizations

1.09 The principal kinds of property and liability insurance organizations are

a. *stock companies*, which are corporations organized for profit with ownership and control of operations vested in the stockholders. Generally, the stockholders are not liable in case of bankruptcy or impairment of capital.

b. *mutual companies*, which are organizations in which the ownership and control of operations are vested in the policyholders. On the expiration of their policies, policyholders lose their rights and interests in the entity. Many states require the net assets of a mutual insurance entity in liquidation to be distributed among the current policyholders of the entity, and the prior policyholders have no claim against the assets. Most major mutual entities issue nonassessable policies as provided under state laws; if a mutual entity is not qualified to issue such policies, however, each policyholder is liable for an assessment equal to at least one annual premium in the event of bankruptcy or impairment of minimum equity requirements. Many mutual insurance entities are seeking enhanced financial flexibility and access to capital to support long-term growth and other strategic initiatives. Because of many economic and regulatory factors, as well as increased competition, some mutual insurance entities have chosen to demutualize or to form mutual insurance holding entities.

c. *reciprocal or interinsurance exchanges*, which are composed of a group of persons, firms, or corporations, commonly termed subscribers, who exchange contracts of insurance through the medium of an attorney-in-fact. Each subscriber executes an identical agreement empowering the attorney-in-fact to assume, on the subscriber's behalf, an underwriting liability on policies covering the risks of the other subscribers. The subscriber assumes no liability as an underwriter on policies covering his or her own risk; the subscriber's liability is several and not joint and is limited by the terms of the subscriber's agreement. Customarily, the attorney-in-fact is paid a percentage of premium income, from which he or she pays most operating expenses, but some exchanges pay his or her own operating expenses and compensate the attorney-in-fact at a lower percentage of premiums or by some other method.

d. *public entity risk pools*, which are cooperative groups of governmental entities joining together to finance exposures, liabilities, or risks. Risk may include property and liability, workers' compensation, employee health care, and so forth. A pool may be a stand-alone entity or be included as part of a larger governmental entity that acts as the pool's sponsor. Stand-alone pools are sometimes organized or sponsored by municipal leagues, school associations, or other kinds of associations of governmental entities. A stand-alone pool is frequently operated by a board that has as its membership one member from each participating government. It typically has no publicly elected officials or power to tax. Public entity risk pools normally should be distinguished from private pools, which are organized under the Risk Retention Act of 1986. These private pools, or risk retention groups, can provide only liability coverage, whereas public entity risk pools organized under individual state statutes can provide several kinds of coverage. The four basic kinds of public entity risk pools are

i. *risk-sharing pools*, which are arrangements by which governments pool risks and funds and share in the cost of losses.

ii. *insurance-purchasing pools*, which are arrangements by which governments pool funds or resources to purchase commercial insurance products. These arrangements are also called *risk-purchasing groups*.

iii. *banking pools*, which are arrangements by which money is made available for pool members in the event of loss on a loan basis.

iv. *claims-servicing* or *account pools*, which are arrangements by which pools manage separate accounts for each pool member from which the losses of that member are paid.

A pool can serve one or several of those functions. Pools that act *only* as banking or claims-servicing pools do not represent transfer of risk. Those pools are not considered insurers and do not need to report as such.

e. *private pools.* Because of the unavailability and unaffordability of commercial liability insurance, Congress enacted the Risk Retention Act of 1986. This act allows the organization of private pools for the purpose of obtaining general liability insurance coverage. Two basic types of private pools are allowed:

i. *Risk retention groups*. An insurance entity formed by the members of the private pool primarily to provide commercial liability insurance to the members.

ii. *Purchasing groups*. Members of a private pool purchase commercial liability insurance on a group basis.

Methods of Producing Business

1.10 The marketing department of an insurance entity is responsible for sales promotion, supervision of the agency or sales force, and sales training. Property and liability insurance entities may produce business through a network of agents (agency companies) or through an employee sales force (direct writing companies), or they may acquire business through insurance brokers or through direct solicitation. A combination of methods may also be used. The distinctions among an agent, a broker, and a salesperson are based on their relationships with the insurance entity.

1.11 *Agents.* Insurance agents act as independent contractors who represent one insurance entity (exclusive agents) or more than one entity (independent agents) with express authority to act for the entity in dealing with insureds.

1.12 General agents have exclusive territories in which to produce business. They agree to promote the entity's interest, pay their own expenses, maintain a satisfactory agency force, and secure subagents. They may perform a significant portion of the underwriting. They may also perform other services in connection with the issuance of policies and the adjustment of claims, including negotiating reinsurance on behalf of the insurer, which neither local agents nor brokers are authorized or expected to do.

1.13 Local and regional agents are authorized to underwrite and issue policies but are not usually given exclusive territories. They usually report either to entity branch offices or directly to the entity's home offices. Agents are generally compensated by commissions based on percentages of the premiums they produce. Because of their greater authority and duties, general agents usually receive higher percentages than local or regional agents.

1.14 Agents have the power to bind the entity, which means that the insurance is effective immediately, regardless of whether money is received or a policy is issued. Generally, agents are considered to have vested rights in the renewal of policies sold for insurance entities. The entity cannot, however, compel independent agents to renew policies, and the agents may place renewals with other entities.

1.15 *Brokers.* Insurance brokers represent the insureds. As a result, brokers do not have the power to bind the entity. Brokers solicit business and submit it for acceptance or rejection with one or more insurance entities. Brokers may submit business directly to an entity or through general or local agents or through other brokers. Brokers are compensated by commissions paid by insurance entities, normally percentages of the premiums on policies placed with the entities, or through fees paid by the insured. A growing trend among large brokers is toward fee agreements, wherein commissions are either not accepted from the respective insurer or commissions received from the insurer by the broker are offset against the fees to be paid by the insured.

1.16 *Direct writing.* Direct writing entities sell policies directly to the public, usually through salespeople, thus bypassing agents and brokers. Direct writing may be done from the entity's home office or through branch sales offices. Underwriting and policy issuance may also be done from the home office or branches. The salespeople may be paid commissions, straight salaries, or a commission incentive with a base salary. Salespeople generally have the power to bind the entity; however, the entity retains the right to cancel the policy, generally for up to 60 days.

1.17 Direct response advertising or mass marketing is also used for producing business. This results in sales to many people simultaneously, with single programs to insure a number of people or businesses. Such methods use direct billing techniques that may also permit individuals to pay premiums by salary deductions, credit cards or as a direct draft against a checking account.

Major Transaction Cycles

Underwriting of Risks

1.18 Underwriting includes evaluating the acceptability of the risk, determining the premium, and evaluating the entity's capacity to assume the entire risk.

1.19 *Evaluating risks.* Evaluating risks and their acceptance or rejection involves (*a*) a review of exposure and potential loss based on both the review of policies, past claims experience, and the endorsements to existing policies and (*b*) an investigation of risks in accordance with procedures established by entity policy and state statutes. For example, applicants for automobile insurance may be checked by reference to reports on driving records issued by a state department of motor vehicles. A commercial enterprise wanting to purchase property insurance coverage may need to provide certain types of information when applying for coverage, for example, claims history, an engineering survey, a fire hazard survey, or similar investigations. In addition, an entity's underwriting policy may establish certain predetermined criteria for accepting risks. Such criteria often specify the lines of insurance that will be written as well as prohibited exposures, the amount of coverage to be permitted on various kinds of exposure, the areas of the country in which each line will be written, and similar restrictions.

1.20 *Setting premium rates.* Establishing prices for insurance coverage is known as the rate-making process, and the resultant rates that are applied to some measure of exposure (for example, payroll or number of cars) are referred to as *premiums*. Determining premiums is one of the most difficult tasks in the insurance business. The total amount of claims is not known at the time the insurance policies are issued and, for many liability policies, is not known until years later. Determining proper premium rates is further complicated by the fact that no two insurable risks are exactly alike. The intensity of competition among hundreds of property and liability insurance entities in the United States is also significant in setting premiums.

1.21 Premium rates may be established by one of three methods:

a. *Manual rating*, which results in standard rates for large groups of similar risks, used, for example, in many personal lines such as automobile insurance

b. *Judgment rating*, which depends on the skill and experience of the rate-maker, used generally for large or unusual risks such as ocean marine insurance

c. *Merit rating*, which begins with an assumed standard or "manual" rate that is adjusted based on an evaluation of the risk or the insured's experience in past or current periods, used in many commercial lines such as workers' compensation

1.22 The transaction cycle for premiums is described in detail in chapter 3, "The Premium Cycle."

1.23 *Reinsurance*. Insurance entities collect amounts from many risks subject to insurable hazards; it is expected that these amounts will be sufficient in the aggregate to pay all losses sustained by the risks in the group. To do so, the number of risks insured needs to be large enough for the law of averages to operate.[2] However, insurance entities are often offered, or may be compelled to accept, insurance of a class for which they do not have enough volume in the aggregate to permit the law of averages to operate. Further, entities often write policies on risks for amounts beyond their financial capacities to absorb; or an entity may write a heavy concentration of policies in one geographic area that exposes the entity to catastrophes beyond its financial capabilities. Ordinarily, all or part of such risks are passed on to other insurance or reinsurance entities.

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[2] That is, the statistical tendency of expected losses over a large population of risks.

1.24 Spreading of risks among insurance entities is called *reinsurance*. The entity transferring the risk is called the *ceding entity*, and the entity to which the risk is transferred is called the *assuming entity*, or the *reinsurer*. Although a ceding entity may transfer its risk to another entity through reinsurance, it does not discharge its primary liability to its policyholders. The ceding entity remains liable for claims under the policy; however, through reinsurance, the ceding entity reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the assuming entity for the reinsured portion of the loss. The ceding entity is also exposed to the possibility that the reinsurer will not be able to reimburse the ceding entity.

1.25 The term *portfolio reinsurance* is applied to the sale of all or a block of an entity's insurance in force to another entity. This kind of reinsurance is frequently used when an entity wishes to withdraw from a particular line, territory, or agency. In portfolio reinsurance, the assuming entity generally undertakes responsibility for servicing the policies—collecting the premiums, settling the claims, and so on—and the policyholder subsequently deals directly with the assuming entity.

1.26 *Fronting*. Fronting is an arrangement between two or more insurers whereby the fronting entity issues a policy and then cedes all or substantially all the risk through a reinsurance agreement to the other insurer(s) (the fronted entity) in return for a ceding commission. As with other reinsurance contracts, the fronting entity remains primarily liable on the insurance contract with the insureds. Fronting arrangements usually are initiated by fronted companies that are not authorized to write insurance in particular states.

1.27 The principal kinds of reinsurance agreements and the mechanics of reinsurance are discussed in detail in chapter 6, "Reinsurance."

Pooling, Captives, and Syndicates

1.28 *Pooling*. The term *pooling* is often used to describe the practice of sharing among groups of affiliated insurance entities all or portions of the insurance business of the groups. Each premium written by the affiliated companies is customarily ceded to one entity; then, after allowing for any business reinsured outside the group, the premiums are in turn ceded back in agreed-upon ratios. Claims, claim adjustment expenses, commissions, and other underwriting and operating expenses are similarly apportioned. Each member of the group shares pro rata in the total business of the group, and all achieve similar underwriting results. Another kind of pooling involving sharing of risks among governmental entities is discussed in paragraph 1.09*d*.

1.29 *Underwriting pools, associations, and syndicates*. Underwriting pools, associations, or syndicates are formed by several independent entities or groups of entities in joint ventures to underwrite specialized kinds of insurance or to write in specialized areas. These groups are often operated as separate organizations having distinctive names and their own staffs of employees. The pools, associations, or syndicates may issue individual or syndicate policies on behalf of the member entities, which share in all such policies in accordance with an agreement, or policies may be issued directly by the member entities and then reinsured among the members in accordance with the agreement. The agreement stipulates the group's manner of operation and the sharing of premiums, claims, and expenses. Such groups customarily handle all functions in connection with the specialized business that would otherwise have to be handled by specific departments in each of the member companies. This kind of arrangement usually is more economical in handling the business for the members.

1.30 *Captives.* Noninsurance businesses[3] try to use various methods to minimize their cost of insurance. Other than retaining the risk (that is, self-insurance), perhaps the most conventional method is the use of captive insurers. Captive insurers are wholly owned subsidiaries created to provide insurance to the parent entities. Captives were originally formed because no tax deductions are allowed if risks are not transferred, whereas premiums paid to insurers are tax deductible. Many captives are chartered in locales in which the business climate is receptive to their formation. However, in 1977 the IRS ruled that premiums paid to an offshore captive would not be allowed as a deductible expense unless a significant volume of insurance was placed with the captive firm by entities outside the consolidated group. As a result, several states, including Vermont, South Carolina, Hawaii, and the District of Columbia, have passed captive regulations and actively encouraged on-shore formation. The Tax Reform Act of 1986 subjects any U.S. person who owns stock in a 25 percent or more U.S.-owned foreign insurance company to current taxation based on its pro rata share of income arising from insuring risks of U.S. shareholders and related parties.

Processing and Payment of Claims

1.31 An insurance entity's claim department accepts, investigates, adjusts, and settles claims. The first step in the claims process is for the insured to notify the entity that a loss has occurred. The insured reports the loss to the agent, who will either help the insured to prepare or will prepare a loss report, which will be forwarded to the insurance entity. The second step is investigation and adjustment, which is designed to determine whether a loss occurred and whether the loss is covered by the policy. Entities generally use claims adjusters, who may be employees of the insurance entities or of the agents, to investigate claims. Insurance entities may also use outside organizations to adjust claims.

1.32 *Adjustment bureaus.* Insurance entities establish adjustment bureaus to investigate and settle some or all of the claims of the member companies. Subject to certain limitations, an adjustment bureau adjusts claims and negotiates the settlement of claims for each entity, with each entity retaining the final power of approval or disapproval. Expenses of the adjustment bureau are shared by all members on an equitable basis generally determined by the number or dollar volume of claims referred to it for adjustment.

1.33 *Independent adjusters.* Insurance entities engage independent adjusters who charge stipulated fees for their services to investigate and adjust certain claims. The adjustment process also includes estimating the loss. The adjuster will help determine the amounts of losses and the reserves to be recorded.

1.34 The third step of the claims process is claim settlement, either payment or denial of a claim. After settlement (through negotiation or court action) with a claimant, a check or draft is issued for the amount of the adjusted claim.

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[3] Technical Questions and Answers sections 1200.06–.16 (AICPA, *Technical Practice Aids*) provide information on finite insurance products utilized by noninsurance enterprises. The guidance provides information to assist insurance customers and practitioners in identifying the relevant literature to consider in addressing their specific facts and circumstances.

Upon receipt of payment, the claimant generally signs a release indicating that final settlement has been received.

1.35 The transaction cycle for claims is discussed in more detail in chapter 4, "The Loss Reserving and Claims Cycle."

Investments

1.36 Property and liability insurance entities function as conduits of funds. They collect funds, known as premiums, from those desiring protection from financial loss and disburse funds to those who incur such losses. Between receipt of premiums and payment of losses, which can be long periods for third-party claims, the entities invest these funds.

1.37 Because insurance entities must be able to meet the claims of their policyholders, their investments generally should be both financially sound and sufficiently liquid. To ensure that entities will be able to meet their obligations, statutory restrictions have been placed on their investment activities. Although statutes and regulations vary from state to state, most states specify maximum percentages of an entity's assets or surplus or both that may be placed in various kinds of investments. In addition, regulatory authorities may require that some investments be deposited with the state insurance departments as a condition for writing business in those states. Investment standards and restrictions for public entity risk pools differ significantly from standards for insurance entities. In some jurisdictions, public entity risk pools must follow regulations governing the investment of public funds. Invested assets consist primarily of bonds and marketable equity securities, but investments are also commonly made in mortgage loans and income-producing real estate. In addition, the insurance industry has been increasingly utilizing options, financial futures, and other instruments in its investment activities.

1.38 Many insurance entities have separate investment departments responsible for managing the entities' investable funds. Insurers are required by many states to make investments so that the maturities of their investment portfolios match their claims payment patterns. This is generally referred to as *asset and liability management or asset and liability matching*—that is, funds are invested so that the income from these investments plus maturities will meet the ongoing cash flow needs of the entity. This matching approach requires a correct mix of long and short term investments which can change depending on the current economy.

1.39 The transaction cycle for investments is discussed in more detail in chapter 5, "The Investment Cycle."

Accounting Practices

1.40 Although the increased use of systems application software interfaced with general ledger packages has encouraged the use of full accrual accounting records by many insurers, many entities still maintain their general ledger on a modified cash basis and then prepare financial statements for regulatory filings on an accrual basis. The accounting practices used to prepare such statutory financial statements differ in some respects from United States generally accepted accounting principles (U.S. GAAP), as summarized in table 1-1.

1.41 Under statutory accounting practices (SAP), as defined in Statement of Statutory Accounting Principle (SSAP) No. 4, *Assets and Nonadmitted Assets*, paragraph 2, "For the purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. . . . These assets shall then be evaluated to determine whether they are admitted." Paragraph 3 of SSAP No. 87, *Capitalization Policy, an Amendment to SSAP Nos. 4, 19, 29, 73, 79, and 82*, supersedes paragraph 3 of SSAP No. 4, and discusses nonadmitted assets, "As stated in the Statement of Concepts, 'The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet,' and are, therefore, considered nonadmitted." SSAP Nos. 87 and 20, *Nonadmitted Assets*, require that assets be considered nonadmitted if they are not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*. A nonadmitted asset should be charged against surplus unless specifically addressed in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*. For additional information on SAP, see paragraph 1.63 and sections following.

State Insurance Regulation

1.42 The insurance industry is deemed to be a business vested with the public interest and is regulated by the states. Statutes in each state provide for the organization and maintenance of an insurance department responsible for supervising insurance entities and enforcing compliance with the law. Property and liability insurance entities are subject to formal regulation by the insurance department of the state in which they are domiciled and are also subject to the insurance regulations of the states in which they are licensed to do business.

1.43 Although statutes vary from state to state, they have as their common principal objective the development and enforcement of measures designed to promote solvency, propriety of premium rates, fair dealings with policyholders, and uniform financial reporting. State statutes (*a*) restrict investments of insurance entities to certain kinds of assets, (*b*) prescribe methods of valuation of securities and other assets, (*c*) require maintenance of reserves, risk-based capital, and surplus, and (*d*) define those assets not permitted to be reported as admitted assets.

1.44 The states regulate insurance premium rates to ensure that they are adequate, reasonable, and not discriminatory. In a 1944 decision, the United States Supreme Court held that insurance is interstate commerce and as such is subject to regulation by the federal government. However, in 1945 Congress passed the McCarran-Ferguson Act, which exempts the insurance business from antitrust laws. Although Congress insisted that the federal government has the right to regulate the insurance industry, it stated in the McCarran-Ferguson Act that the federal government would not regulate insurance as long as state legislation provided for the supervision of insurance entities, including rate making. The following practices are protected by the McCarran-Ferguson Act:

- Pooling of statistical data for rate making
- Standard policy forms and standardized coverage
- Joint underwriting and joint reinsurance (such as insurance pools for exceptional hazards)

- Tying of various lines of insurance, that is, making the purchase of lines of insurance that are unprofitable to the insurance entity conditional on the purchase of profitable lines (***Note:*** Tying is not permitted in certain states.)

1.45 All states have passed legislation requiring insurance commissioners to review, with or without prior approval, most rates charged by insurance entities. An entity must file most rates with the insurance department of each state in which it is authorized to do business. A number of states also require formal or tacit approval of rates by respective state insurance departments.

1.46 To promote fair dealing with policyholders, state statutes provide for certain standard provisions to be incorporated in policies and for the insurance departments to review and approve the forms of policies. Insurance agents, brokers, and salespeople must qualify for and obtain licenses granted by the insurance department of a state before they may conduct business in the state.

1.47 To promote uniform financial reporting, as previously discussed, the statutes provide for annual or more frequent filings with the insurance departments in a prescribed form.

1.48 In a majority of states, insurance entities may not be organized without the authorization of the insurance department and, in states in which such authorization is not necessary, approval by the insurance department is necessary for the completion of organization.

1.49 An insurance department generally consists of an insurance commissioner or superintendent in charge, one or more deputies, and staffs of examiners, attorneys, and clerical assistants. Many larger insurance departments also employ actuaries to review rate filings and to assist in the monitoring of financial solvency, principally relating to loss reserves. A commissioner usually is granted discretionary powers and can issue rules and regulations necessary to ensure compliance with state statutes.

National Association of Insurance Commissioners

1.50 To create greater uniformity both in the laws and their administration and to recommend desirable legislation in state legislatures, the state commissioners of insurance organized an association that is known today as the NAIC. The activities of the NAIC include monitoring financial condition and providing guidance on financial reporting and state regulatory examinations. The work of the NAIC over the years has helped to eliminate many conflicts of state law and to promote more uniform and efficient regulation of insurance entities. In June 1989, the Financial Regulation Standards were developed, which established baseline requirements for an effective regulatory system in each state. The NAIC Financial Regulation Standards and Accreditation Program was subsequently developed by the NAIC to provide states with guidance regarding these standards. The standards are divided into 3 categories: (1) laws and regulations, (2) regulatory practices and procedures, and (3) organizational and personnel practices. Accounting, financial reporting, and auditing requirements are included in the standards. Mandating certain requirements and certifying that the states are in compliance provides a degree of assurance that regulators have adequate authority to regulate insurers, have the resources to carry out that authority, and have in place administrative practices designed for effective regulation.

Federal Regulation—Securities and Exchange Commission

1.51 Because property and liability insurance entities are subject to state insurance department supervision and regulations, the Securities Exchange Act of 1934 contains certain provisions exempting stock property and liability insurance entities from registration with the Securities and Exchange Commission (SEC). However, a large number of entities have registered under the act, either in connection with the listing of their shares on a national securities exchange or because they have formed holding companies that do not qualify for exemption under the act. Property and liability insurance entities registered under the act must comply with the SEC's periodic reporting requirement and are subject to the proxy solicitation and insider-trading rules. Insurance entities making public offerings are required to file under the Securities Act of 1933 and must thereafter comply with the annual and periodic reporting requirements of the Securities Exchange Act of 1934. However, these entities are not under the proxy solicitation or insider-trading rules of the Securities Exchange Act of 1934 as long as they meet the attendant provisions for exemption. Insurance entities that are SEC registrants should follow Article 7 of SEC Regulation S-X, SEC Industry Guide 6, and applicable Staff Accounting Bulletins, which prescribe the form and content of financial statements.

1.52 Additionally, the aforementioned entities subject to SEC rules and regulations are required to follow the provisions of the Sarbanes-Oxley Act of 2002 and related SEC regulations implementing the act. Their outside auditors are also subject to the provisions of the act and to the rules and standards issued by the Public Company Accounting Oversight Board (PCAOB), subject to SEC oversight. For further information on these rules and regulations, see chapter 2, "Audit Considerations."

1.53 *Disclosure information—general recommendations.*[4] SEC staff recommendations for improved disclosures include, but are not limited to the following:

a. *Loss reserves*. The SEC staff desires improved explanations for changes in reserve estimates. More specifically, disclosure should show changes in estimates by line of business, discussion of the range of estimates by line of business, improved explanations of the facts involved in the reserve estimates, or new information since the last report date underlying the improved insight on estimates and a more robust discussion of the entity's remaining exposure to uncertainty. Additional disclosure for incurred but not reported reserves and case reserves and by line of business should also be considered. The staff has expressed concern that investors expect a higher degree of precision on loss reserve estimates than exists. Therefore, investors should be provided with more detailed information relating to uncertainties inherent in the estimates.

Note that disclosures for the liability for unpaid claims and claim adjustment expenses and reinsurance recoverables on paid and

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[4] In March and September 2008, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) sent out illustrative letters to public entities identifying a number of disclosure issues surrounding the fair value of financial instruments they may wish to consider in preparing Management's Discussion and Analysis for their reports on Forms 10-Q, Form 10-K, or Form 20-F. Readers should familiarize themselves with these letters that can be found on the SEC website at www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm and www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm.

unpaid claims should enable the reader to understand (*a*) management's method for establishing the estimate for each material line of business and how the methodology is appropriate for the reporting, development, and payment patterns inherent in the business line, (*b*) any changes to significant assumptions used to determine the current period estimate from the assumptions used in the immediately preceding period, the reason for the change, and the impact of the change, and (*c*) the reasonably likely variability inherent in the current estimate and the impact that variability may have on future reported results, financial condition, and liquidity. Disclosure about the liability for unpaid claims and claim adjustment expenses should identify underlying causes, not just intermediate effects, and should include a quantitative as well as qualitative discussion. Disclosure should be concise and to the point and should avoid unnecessary repetition. Readers should refer to Section II R of the SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance, which can be accessed at www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf.

b. *Other than temporary impairments of securities*[*] *(general)*. Discussion should include the entity policy for evaluating other than temporary impairments, the amount of impairment and whether those factors would affect other investments. The SEC staff expressed an expectation for this level of disclosure for each quarter for all material impairments.

c. *Realized losses on investments*. Discussion should include the amount of loss and the fair value at the date of sale as well as the reasons for sales if the entity previously asserted the ability and intent to hold the investment to maturity, in order to justify the lack of an impairment loss. The SEC expressed an expectation for this level of disclosure each quarter for all material losses.

d. *Unrealized losses on investments*. Discussion should include concentrations of securities with a loss. Additionally, disclosure should include the length of time that securities have been recorded with an unrealized loss, in tabular format, by class of security, and broken out between investment and noninvestment grade investments. The SEC staff expressed an expectation for this level of disclosure each quarter for all material unrealized losses.

e. *Accounting policy disclosures*. Registrants should provide more specific information regarding critical accounting policies, especially if the policies are in areas where there is known diversity in practice.

f. *Contractual obligations*. The SEC staff recommended increased disclosures regarding insurance contracts in the contractual obligations table in Form 10-K. Disclosures include variables such as future lapse rates and interest crediting rates.

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[*] For the application of generally accepted accounting principles (U.S. GAAP), refer to FASB ASC 320, *Investments—Debt and Equity Securities*.

For statutory accounting practices, refer to Statement of Statutory Accounting Principle No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*, that adopts the GAAP guidance in paragraph 16 of FSP FAS No. 115-2 and FAS No. 124-2 (FASB ASC 320), with an effective date of January 1, 2009, with early adoption permitted. For additional specifics, see chapter 5, "The Investment Cycle."

1.54 *SEC disclosures—Sarbanes-Oxley Act of 2002 implementation.* In response to passage of the Sarbanes-Oxley Act of 2002, the SEC and PCAOB have issued (or are issuing) additional rules and regulations specifying compliance. Additionally, in June 2006, state regulators adopted changes to the Annual Financial Reporting Model Regulation to be effective in 2010 by considering certain provisions of the act. For additional information, see chapter 2. Sections of the act that contain disclosure requirements include Sections 302, 401(a), 401(b), 404, 406, and 407:

a. Section 302—*Certification of Disclosure in Companies Quarterly and Annual reports.* CEOs and CFOs (or their equivalents) are now required to certify the financial and other information contained in quarterly and annual reports and make certain disclosures. Additionally, Department of Justice certifications (governed by Section 906 of the act) became effective upon enactment of the act.

b. Section 401(a)—*Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*. This section of the act requires that each annual and quarterly financial report disclose specific material transactions and relationships.

c. Section 401(b)—*Conditions for Use of Non-GAAP Financial Measures*, discusses the disclosure of pro forma financial information in any report filed with the SEC, or in any public disclosures or press releases. The term *non-GAAP financial measures* rather than *pro forma financial information*, is used to eliminate confusion with pro forma disclosures that are required under existing SEC rules and regulations. As required by the act, whenever an entity presents a non-GAAP financial measure, Regulation G will require presentation of a numerical reconciliation to the most directly comparable measurement calculated using GAAP. Regulation G also explicitly prohibits the presentation of inaccurate or misleading non-GAAP financial measures. Rule 401(b) defines a *non-GAAP financial measure* as a numerical measure of an entity's historical or future financial performance, financial position, or cash flows that excludes (includes) amounts, or is subject to adjustments that have the effect of excluding (including) amounts, that are included (excluded) in the most directly comparable measure calculated in accordance with GAAP.

d. Section 404—*Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.* See chapter 2 of this guide for additional information.

e. Sections 406/407—*Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.* (Code of Ethics and Audit Committee financial expert disclosures, respectively).

1.55 *Additional insurance industry information for non-GAAP financial measures.* The definition of non-GAAP financial measures specifically excludes measures that are required to be disclosed by GAAP, SEC rules, or an applicable system of regulation imposed by a government, governmental authority or self-regulatory organization. Therefore, ratios (for example, statutory) used by insurance registrants in SEC filings to describe the results of operations are considered outside the scope of the non-GAAP rules so long as those ratios are identical (in terms of both formula and result) to those presented in required filings with insurance regulators.

1.56 In addition to Regulation G, the SEC also amended Regulations S-K [Item 10(e)] to impose additional requirements and restrictions on the disclosure of non-GAAP financial measures included in a filing with the SEC. Among other things, the amendments to Regulations S-K prohibit the presentation of performance measures that exclude charges or gains identified as "nonrecurring, infrequent or unusual," unless the excluded items meet certain conditions. In the past, many insurance entities had used the term *operating earnings* (or similar non-GAAP terms) in discussing financial results included in a filing with the SEC. Operating earnings can be defined in a variety of different ways; however, the most common definition is net income excluding after-tax realized investment gains and losses. Under non-GAAP rules, the term *operating earnings* is now prohibited from being used in SEC filings because it is considered a performance measure that is adjusted to eliminate or smooth items (realized investment gains and losses), which have either occurred in the prior two years or are likely to recur within 2 years from the balance-sheet date.[†]

Federal Regulation—Terrorism

1.57 Property and liability entities must follow the Terrorism Risk Insurance Act of 2002 (TRIA) and its amendments, the Terrorism Insurance Extension Act of 2005 and the Terrorism Risk Insurance Program Reauthorization Act of 2007. TRIA created a federal backstop for property and casualty insurance entities covering acts of terrorism in excess of $5 million. Insurance entities would pay a deductible equal to 7, 10, and 15 percent of prior year premiums in 2003, 2004, and 2005, respectively. The government would then cover 90 percent of losses exceeding the deductible with insurance entities liable for the other 10 percent. Federal payments would be capped at $90 billion, $87.5 billion, and $85 billion in 2003, 2004, and 2005, respectively. Among other matters, the updated TRIA also mandates that insurers should make terrorism insurance available under all of its property and casualty insurance policies on the same terms and conditions as the underlying policy.

1.58 Effective January 1, 2006, the Terrorism Insurance Extension Act of 2005 added new program years 4 and 5 (2006 and 2007, respectively) to the definition of insurer deductible. The insurer deductible is set as the value of an insurer's direct earned premiums for (newly defined) commercial property and casualty insurance over the immediately preceding calendar year multiplied by 17.5 percent and 20 percent for 2006 and 2007, respectively. A program trigger prohibits payment of federal compensation unless the aggregate industry insured losses from an act of terrorism exceeds $50 million and $100 million for 2006 and 2007, respectively. Additionally, subject to the program trigger, the federal share is 90 percent and 85 percent of an amount that exceeds the applicable insurer's deductible in 2006 and 2007, respectively.

1.59 In January 2006, the NAIC adopted two model disclosure forms to assist insurers in complying with the Terrorism Risk Insurance Extension Act of 2005. The model disclosure forms may be used by insurers to meet their

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[†] Readers should be aware of the revised SEC Compliance and Disclosure Interpretation *Non-GAAP Financial Measures* (specifically Question 102.03 that addresses adjusting a non-GAAP financial performance measures) issued in January 2010 that can be found on the SEC website at www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

obligation under the rules and provide policy holders of the status of current coverage. Insurers must comply with state law and this act and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements, and the provisions of this act.

1.60 On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act of 2007 was signed into law. This act extends the revised TRIA through December 31, 2014. See www.treasury.gov/trip for recoupment provision revisions and other specifics not discussed here.

1.61 Additionally, the NAIC's Terrorism Insurance Implementation Working Group adopted a model bulletin intended to help state insurance regulators advise insurers about regulatory requirements related to the recent extension of the TRIA. The model bulletin provides guidance to insurers related to rate filings and policy language that state regulators would find acceptable to protect U.S. businesses from acts of terrorism. The model bulletin describes important changes that are contained in the Terrorism Insurance Extension Act of 2005 and informs insurers regarding whether rate and policy form filings might be needed. For additional information see www.naic.org/topics/topic_tria.htm.

Industry Associations

1.62 The property and liability insurance industry has many industry associations to help with the multitude of technical problems that arise in the course of business. These organizations also monitor regulatory developments and provide public relations for the industry. See appendix G, "Information Sources," for a list.

Statutory Accounting Practices

1.63 State insurance departments require insurance entities to maintain records in accordance with SAP. Statutory accounting employs those accounting principles and practices prescribed or permitted by an insurer's domiciliary insurance department and in some instances, by the insurance departments of other states in which the insurer is licensed to write business (that is, authorized to do business).

1.64 The NAIC codified SAP for certain insurance entities, resulting in a revised *Accounting Practices and Procedures Manual* (the manual). It is published annually as of March containing all updates adopted through December 31 of the preceding year. Changes adopted during the year are available on the NAIC website under the Accounting Practices and Procedures Task Force, notably the Statutory Accounting Principles Working Group and the Emerging Accounting Issues Working Group. The primary SAP material in the manual is presented in SSAPs and with interpretations of the Emerging Accounting Principles Working Group. Other related material is also included in the manual. State insurance laws and regulations require insurers to comply with the guidance provided in the manual except as prescribed or permitted by state law. States adopted the manual in whole, or in part, as an element of prescribed SAP in the states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. The NAIC published "States' Prescribed Difference from NAIC Statutory Accounting Principles," organized by state including reference to each state's applicable statute or regulation, as a means of providing further information to regulators, public accountants, and entity personnel regarding these differences.

1.65 In its March 2010 *Accounting Practices and Procedures Manual*, the NAIC revised its statutory hierarchy taking into consideration Financial Accounting Standards Board (FASB) Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, which essentially reduces the U.S. GAAP hierarchy to two levels (one that is authoritative and one that is not). The preamble of the revised manual notes the following as the statutory hierarchy, which is not intended to preempt state legislative or regulatory authority:

Level 1:

- The SSAPs, including GAAP reference material to the extent adopted by the NAIC from FASB ASC[5] (FASB ASC or GAAP guidance)

Level 2:

- Consensus positions of the Emerging Accounting Issues Working Group as adopted by the NAIC

Level 3:

- NAIC annual statement instructions
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

Level 4:

- Statutory Accounting Principles Statement of Concepts[6]

Level 5:

- Sources of nonauthoritative GAAP accounting guidance and literature, including (*a*) practices that are widely recognized and prevalent either generally or in the industry, (*b*) FASB concept statements, (*c*) AICPA Issue Papers, (*d*) International Financial Reporting Standards, (*e*) pronouncements of professional associations or regulatory agencies, (*f*) Technical Questions and Answers included in the AICPA *Technical Practice Aids*, and (*g*) accounting textbooks, handbooks, and articles.

If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established Statutory Accounting Principles (SAP). If an established SAP from one or more sources in level 2 or 3 is relevant to the circumstances, the

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[5] Effective September 15, 2009, FASB ASC is the source of authoritative U.S. generally accepted accounting principles. As of that date, FASB ASC superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in FASB ASC is nonauthoritative.

[6] The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concept Nos. 1, 2, 5, and 6 to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy, the FASB concepts statements shall be included in level 5 and only those concepts unique to statutory accounting as stated in the statement are included in level 4.

preparer, regulator or auditor should apply such principle. If there is a conflict between SAP from one or more sources in level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow level 2 treatment over level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*.

1.66 The manual, the NAIC's annual statement instructions, *Examiners Handbook*, *Valuation of Securities Manual*, committee minutes, model rules, regulations, and guidelines provide sources of SAP. Some states may issue circular letters or bulletins describing their positions on various areas of accounting. In areas in which specific accounting practices are not prescribed, widely recognized practices may be permitted in a given state or specific accounting applications may be approved by the state insurance department, either orally or in writing. Auditors are able to review state examiners' reports to obtain evidence of accounting practices that have either been explicitly or implicitly accepted on examination.

1.67 Each state insurance department requires all insurance entities licensed to write business in that state to file an annual statement, also referred to as the convention blank, statutory blank, or simply the blank, with the state insurance commissioner for each individual insurance entity. Most states require the blank to be filed by March 1 of the following year. All states require that the annual statement for the calendar year be comparative, presenting the amounts as of December 31 of the current year and the amounts as of the immediately preceding December 31. The annual statement includes numerous supplementary financial data, such as analysis of operations by lines of business and detailed schedules of investments, losses and reinsurance. The NAIC's instructions to the annual statement require that insurance entities file in conjunction with their annual statement (1) an opinion by a qualified actuary concerning the adequacy of reserves and other actuarial items and that such reserves conform with statutory requirements and (2) a narrative document captioned "management discussion and analysis" discussing material changes in significant annual statement line items and material future operating events, similar to the disclosures currently required by the SEC for public entities. The management discussion and analysis is due April 1 of the following year.

1.68 The NAIC requires most insurance entities in all states to file, by June 1, an audited financial report with the insurance commissioners of their state of domicile and all other states in which they are licensed. Exemptions to requirements to file include insurance entities that write less than one million dollars in direct premiums. The financial statements included in the audited financial report should be prepared in a form and using language and groupings substantially the same as the relevant sections of the annual statement of the insurer. The annual audited financial report is to include a reconciliation of differences, if any, between the audited statutory financial statements contained in that report and the annual statement filed with the state commissioner and a written description of the nature of the differences.

1.69 Insurers are required to have their auditors prepare and file an accountants' letter of qualification and a report on significant deficiencies and material weaknesses in internal controls in accordance with the NAIC instructions. Some states also require the filing of an evaluation of accounting procedures and system of internal control letter.[7]

1.70 It may not be necessary for some public entity risk pools and captive insurers to prepare reports on a SAP basis. Enabling legislation generally sets forth such entities' reporting requirements and may require reporting to the state insurance commissioner or state agency. Separate rules may apply to reporting, capitalization requirements, and so forth.

1.71 Insurance entities are examined regularly by state or zone (a group of states) insurance examiners, usually once every three to five years. The annual statements filed with the regulatory authorities are used to monitor the financial condition of insurance entities in the period between examinations and to provide the financial data to help regulate the industry.

1.72 In addition to the audits of financial statements, insurance examiners review compliance with laws or regulations concerning policy forms, premium rates, kinds of investments, composition of the board of directors, members' attendance at board meetings, reinsurance contracts, intercompany transactions, and fair treatment of policyholders. Insurance examiners use the *Examiners Handbook*, a publication of the NAIC that outlines the procedures for conducting an examination as a guide in performing examinations and in preparing reports. Significant revisions were made to the examination approach outlined in the handbook that are effective for examinations conducted in 2010. The revisions incorporate a risk-focused framework and approach to the conduct of examinations. Some of the steps followed in the examination are similar to those followed by independent auditors as the handbook specifies that auditors should consider and include appropriate procedures described in the handbook as the auditor deems necessary.

1.73 Insurance entities prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile, that is, SAP. SAP are considered an other comprehensive basis of accounting as described in AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1).

1.74 Prescribed SAP are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.

Permitted Statutory Accounting Practices[8]

1.75 Permitted SAP include practices not prescribed in paragraph 1.63 but allowed by the domiciliary state regulatory authority. An insurance entity may

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[7] The AICPA publication *A Statutory Framework for Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators* outlines a suggested framework for auditors to follow when reporting internal control deficiencies related to financial reporting identified during the course of an annual audit of statutory financial statements. The framework is an *Other Auditing Publication* that has no authoritative status, but may help the auditor understand and apply the Statements on Auditing Standards.

Additionally, the NAIC adopted revisions to the Annual Financial Reporting Model Regulation in June of 2006. Changes to the Annual Financial Reporting Model Regulation considered certain provisions of the Sarbanes-Oxley Act of 2002. Changed provisions include, but are not limited to, audit committee requirements (effective January 1, 2010), management reporting on internal control over financial reporting (effective December 31, 2010) and auditor partner rotation (effective for 2010 statutory audits and thereafter). For additional information, see chapter 2, "Audit Considerations."

[8] For additional information, see the NAIC *Accounting Practices and Procedures Manual* preamble and its section "Permitted Practices Advance Notification Requirement Question and Answers."

request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of its statutory financial statements if either of the following occur:

a. The entity wishes to depart from the prescribed SAP.

b. The prescribed SAP do not address the accounting for the transaction specifically.

Accordingly, permitted accounting practices differ from state to state, may differ from entity to entity within a state, and may change in the future.

1.76 In instances where the domiciliary state regulator is considering approval of a request for an accounting practice that departs from the NAIC *Accounting Practices and Procedures Manual* and state prescribed accounting practices, the domiciliary regulator must provide notice (to other states) under the requirements as defined in paragraphs 56–57 of the manual's preamble.

1.77 Paragraph 56 states that the notice must disclose the following information regarding the requested accounting practice to all other states in which the insurer is licensed prior to the financial statement filing date:

a. The nature and a clear description of the permitted accounting practice request.

b. The quantitative effect of the permitted accounting practice request with all other approved permitted accounting practices currently in effect as disclosed in appendix A-205, "Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile" for that insurer in the domiciliary state.

c. The effect of the requested permitted accounting practice on a legal entity basis and on all parent and affiliated United States insurance entities, if applicable.

d. Identify any potential effects on and quantify the potential impact to each financial statement line item affected by the request. The potential impact may be determined by comparing the financial statements prepared in accordance with NAIC SAP and the financial statements incorporating the requested permitted accounting practice.

1.78 Paragraph 57 states that the granting of approval for an accounting practice request by the domiciliary state regulator does not preempt or in any way limit any individual state's legislative and regulatory authority.

1.79 The disclosures in this paragraph should be made if (*a*) state prescribed SAP differ from NAIC SAP or (*b*) permitted state SAP differ from either state prescribed SAP or NAIC SAP. The disclosures should be made if the use of prescribed or permitted SAP (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC SAP been followed. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted SAP and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed SAP or NAIC SAP.[9]

1.80 Financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describe how that basis differs from GAAP. As noted in the preamble of the manual, paragraph 59, "To the extent that disclosures required by an SSAP are made within specific notes, schedules, or exhibits to the annual statement, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by annual statement exhibits and schedules (for example, annual audit report) shall include all disclosures required by the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only." Additionally, the provisions of the manual as well as the NAIC Emerging Accounting Issues Working Group Interpretation 04-1, *Applicability of New GAAP Disclosures Prior to NAIC Consideration*, state that GAAP pronouncements do not become part of SAP until and unless adopted by the NAIC. However, provisions of the manual or any other explicit rejection of a GAAP disclosure do not negate the requirements of AU section 623.[‡] For further information, see exhibit 1-1, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," which is reprinted from Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," as amended, of AU section 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .60–.77).[10] The interpretation provides guidance in evaluating whether informative disclosures are reasonably adequate for financial statements prepared on a statutory basis.

U.S. Generally Accepted Accounting Principles[||]

1.81 FASB *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*, classifies insurance contracts as short-duration or long-duration contracts. The classification depends on whether a contract is expected

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[9] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. GAAP financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority, and their monetary effects.

[‡] Footnote 13 of AU section 9623, *Special Reports: Auditing Interpretations of Section 623* (AICPA, *Professional Standards*, vol. 1), states that any explicit rejection of GAAP disclosures would not negate the requirements to include significant and relevant GAAP disclosures in statutory financial statements.

[10] The second amendment to this interpretation occurred in January 2005, subsequent to the Public Company Accounting Oversight Board adoption of the AICPA standards as interim, on April 16, 2003.

[||] The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards (IFRSs) to entites that issue insurance contracts and is now complete. The issuance of IFRS No. 4, *Insurance Contracts*, along with IFRS No. 4 Basis for Conclusions and IFRS No. 4

(continued)

to provide coverage for an extended period. The factors that should be considered in determining whether a particular contract can be expected to remain in force for an extended period follow:

a. *Short-duration contracts*, as discussed in FASB ASC 944-20-15-7, provide insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

b. *Long-duration contracts*, as discussed in FASB ASC 944-20-15-10, generally are not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and which requires the performance of various functions and services (including insurance protection) for an extended period.

Determining whether a contract is short-duration or long-duration requires both judgment and an analysis of the contract terms. Most property and liability insurance contracts currently issued are classified as short-duration contracts.

1.82 Under FASB ASC 944-605-25-1, premiums from short-duration contracts should be recognized as revenue over the contract period in proportion to the amount of insurance provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums should be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

1.83 As noted in FASB ASC 944-30-55-1, certain costs, called *acquisition costs*, vary with and are primarily related to the acquisition of insurance contracts. As discussed in FASB ASC 944-30-25-1 and 944-30-35-1, acquisition costs should be capitalized and charged to expense in proportion to premium revenue recognized. (Particular sections of this Audit and Accounting Guide discuss the requirements of FASB ASC 944, but the reader should refer to FASB ASC 944 itself for specific guidance.)

1.84 FASB ASC 944 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts.

1.85 Governmental Accounting Standards Board (GASB) Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended and interpreted by various GASB pronouncements,

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(footnote continued)

Implementation Guidance, brought to a close phase I of the international insurance project. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, FASB issued an invitation to comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper*, Preliminary Views on Insurance Contracts. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project. The boards are planning to release an exposure draft in the third quarter 2010. Readers should remain alert to any final pronouncements and refer to the revised FASB IASB Memorandum of Understanding.

sets forth the accounting and financial reporting requirements for public entity risk pools. GASB Statement No. 10, as amended and interpreted, is based primarily on FASB ASC 944 but includes certain accounting and financial reporting requirements that differ from FASB ASC 944. In addition to the requirements of GASB Statement No. 10, there are other pronouncements of the GASB that affect accounting and financial reporting by public entity risk pools. For example, GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires pools to make certain disclosures about the credit and market risks of their investments. Further, GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, requires pools to present a statement of cash flows using cash flows categories that differ from those required by FASB Statement No. 95, *Statement of Cash Flows*. This guide does not attempt to highlight the areas in which different accounting or reporting is required for public entity risk pools.

Comparison of U.S. GAAP and SAP

1.86 The differences between SAP and U.S. GAAP result from their differing emphasis, as noted in the preamble of the revised manual, paragraph 10, "GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, U.S. GAAP stresses measurement of emerging earnings of a business from period to period, . . . while SAP stresses measurement of the ability to pay claims in the future." Adequate statutory surplus provides protection to policyholders and permits an entity to expand its premium writing. Accordingly, SAP places a great deal of emphasis on the adequacy of statutory surplus. Table 1-1, "Summary of Statutory Accounting Practices and U.S. Generally Accepted Accounting Principles," presents a summarized comparison of the major differences in accounting treatment between U.S. GAAP and SAP for selected financial statement components. The reader ordinarily should, however, refer to the actual pronouncements for explicit guidance in accounting for transactions in each of the areas.

Table 1-1

Summary of Statutory Accounting Practices and U.S. Generally Accepted Accounting Principles

The following are highlights of significant differences in accounting treatment between codified statutory accounting practices (SAP) and generally accepted accounting principles (U.S. GAAP) for certain financial statement components. As described in paragraph 1.75, statutory accounting may vary by state. The SAP and GAAP references in the chart pertaining to each area are not necessarily inclusive of all guidance applicable to the subject matter.

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
Bonds	Debt securities with a National Association of Insurance Commissioners (NAIC) designation of 1 or 2 should be reported at amortized cost; all other debt securities (NAIC designation 3 to 6) should be reported at the lower of amortized cost or fair value. See Statement of Statutory Accounting Principle (SSAP) No. 26, *Bonds, Excluding Loan-backed and Structured Securities*, and SSAP No. 43, *Loan-backed and Structured Securities*, as amended.	Classified as trading securities or securities available for sale at fair value; classified as held-to-maturity at amortized cost, if positive intent and ability to hold to maturity exist. See Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 320, *Investments—Debt and Equity Securities*.[#]
Common stock	Investments in unaffiliated common stock are generally reported at fair value as stated by the NAIC's Securities Valuation Office. See SSAP No. 30, *Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*.	Fair value. See FASB ASC 320.

(continued)

[#] FASB and the IASB have a joint project on the accounting for financial instruments. The objective of this project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project will replace FASB's and IASB's respective financial instruments standards with a common standard. The boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement.

On May 11, 2010, the IASB published an exposure draft for public comment with proposed changes to the fair value option (FVO) for financial liabilities. The proposals aim to ensure that changes in the credit risk of liabilities that an entity chooses to measure at fair value will not cause volatility in profit or loss. Therefore, the proposals will affect only those entities that choose to apply the FVO to their financial liabilities. The exposure draft *Fair Value Option for Financial Liabilities* is open for comment until July 16, 2010.

On May 26, 2010, FASB issued Proposed Accounting Standards Update (ASU) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*, with comments due September 30, 2010. The proposed ASU can be found on the FASB website at www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1175801893139.

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
Nonredeemable preferred stock	Perpetual preferred† should be valued based on the underlying characteristics of the security, the quality rating as designated by the NAIC, and whether an asset valuation reserve is maintained by the reporting entity. See SSAP No. 32, *Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*.	Fair value. See FASB ASC 320.
Mortgages	First mortgages that are not in default with regard to principal or interest are carried at outstanding principal balance, or amortized cost if acquired at a discount or premium less impairment. See SSAP No. 37, *Mortgage Loans*.	Unpaid balance plus unamortized loan origination fees as prescribed by FASB ASC 310, *Receivables*.
Real estate—Investment	Properties occupied or held for the production of income are reported at depreciated cost less encumbrances less impairment. See SSAP No. 90, *Accounting for the Impairment or Disposal of Real Estate Investments*. Additional information can be found in SSAP No. 40, *Real Estate Investments*.	Depreciated cost, after impairment write-down as per FASB ASC 360, *Property, Plant, and Equipment*.
—Held for sale	Report at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. See SSAP No. 90, as amended by SSAP No. 95, *Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28–Nonmonetary Transactions*. Additional information can be found in SSAP No. 40.	Lower of carrying value or fair value less cost to sell.
Investment in affiliates	Investments in subsidiary, controlled, or affiliated entities should be reported using either a market valuation approach or one of the equity methods. See SSAP No. 97, *Investments in Subsidiary, Controlled, or Affiliated Entities, A Replacement of SSAP No. 88*.‡	Consolidated, equity basis, or cost as appropriate. See FASB ASC 970-323; FASB ASC 835-20; FASB ASC 810, *Consolidations*; and FASB ASC 272, *Limited Liability Entities*.

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
Unrealized gains (losses) for securities	Unrealized gains (losses) on investments held at other than amortized cost are recorded directly to surplus. Guidance comes from a variety of sources, including but not limited to, SSAP Nos. 26, 30, 32, 43, and 86.	Recorded in net income for trading, or other comprehensive income for available for sale, as appropriate (except for held-to-maturity). See FASB ASC 320 and FASB ASC 220, *Comprehensive Income.*
Impairment issues (for marketable debt and equity securities)	If it is determined that a decline in fair value of a bond is other-than-temporary, an impairment loss should be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. For loan backed and structured securities, the impairment guidance within SSAP No. 43R, *Loan-backed and Structured Securities—Revised*, requires bifurcation of "interest" and "noninterest" components for impairment recognition in situations when the entity does not have an intent to sell and has the intent and ability to hold the investment for a period of time sufficient to recover the amortized cost basis: • When an other-than-temporary impairment (OTTI) has occurred because the entity intends to sell or has assessed that they do not	For debt securities, if an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into both of the following: *a*. The amount representing the credit loss *b*. The amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

(continued)

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
	have the intent and ability the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the OTTI recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. • When an OTTI has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the OTTI recognized as a realized loss shall equal the different between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate. See SSAP No. 26, as amended by SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*; No. 30 (excluding investments in common stock of subsidiary, controlled, or affiliated entities), as amended by SSAP No. 99; and No. 32 (including investments in preferred stock of subsidiary, controlled, or affiliated entities), as amended by SSAP No. 99.‖ See also NAIC Interpretation 06-7, *Definition of Phrase "Other Than Temporary."*	The previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. However, the amortized cost basis shall be adjusted for accretion and amortization as prescribed in FASB ASC 320-10-35-35. See FASB ASC 320. For equity securities, if it is determined that the impairment is other than temporary, then an impairment loss shall be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment shall not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new amortized cost basis of the investment and shall not be adjusted for subsequent recoveries in fair value See FASB ASC 320.
Nonadmitted assets	Excluded from the statutory balance sheet and charged to surplus. Major nonadmitted assets include agents' balances/uncollected premiums over three months due, certain amounts of deferred tax assets, certain intangible assets and furniture, fixtures, and equipment.	Not applicable.

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
	See SSAP No. 4, *Assets and Nonadmitted Assets,* No. 6, *Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due from Agents and Brokers*, No. 10, *Income Taxes*, No. 19, *Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*, No. 20, *Nonadmitted Assets,* No. 29, *Prepaid Expenses*, No. 68, *Business Combinations and Goodwill*, No. 87, *Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*, and No. 96, *Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.	
Loss Reserves	Claims, losses, and loss/claim adjustment expenses should be recognized as expense when an event occurs. Liabilities should be established for any unpaid expenses, with a corresponding charge to income. See SSAP No. 55*, Unpaid Claims, Losses and Loss Adjustment Expenses*, No. 62R, *Property and Casualty Reinsurance,* and No. 65, *Property and Casualty Contracts*.	Accrued when insured events occur and based on the estimated ultimate cost of settling the claims. Estimated recoveries are deducted from the liability for unpaid claims. See FASB ASC 944 and Securities and Exchange Commission Staff Accounting Bulletin No. 62, *Discounting by Property and Casualty Insurance Companies*.
Premium Balances Receivable	Uncollected premium balances, and bills receivable for premiums meet the definition of an asset as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of SSAP No. 6.	Due and uncollected premiums are recorded as assets. An appropriate allowance should be established. See FASB ASC 944.
Contract holder dividend liability	Dividends to policyholders immediately become liabilities when they are declared and should be recorded as a liability. See SSAP No. 65.	If limitations exist on the amount of net income from participating insurance contracts of insurers that may be distributed to stockholders, provision is made for accumulated earnings

(continued)

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
		expected to be paid to contract holders, including pro rata portion of dividends incurred to valuation date; If there are no net income restrictions, the future dividends are accrued over the premium-paying period of the contract. Accounting varies depending on the applicability of FASB ASC 944.
Reinsurance	Full credit generally given for authorized reinsurers; net reporting required; reinsurance recognized based on adequate risk transfer; liability for unauthorized reinsurers. See SSAP No. 62R.	Reinsurance recognized based on adequate transfer of risk; provision for uncollectible reinsurance and gross reporting of balance sheet amounts required under FASB ASC 944, net reporting is not allowed unless a right of offset exists as defined in FASB ASC 210-20.
Deferred taxes	Balance sheet should include deferred income tax assets (DTAs) and liabilities (DTLs), the expected future tax consequences of temporary differences generated by statutory accounting, as defined in FASB ASC 740, *Income Taxes*, DTAs are reduced by a statutory valuation allowance adjustment if, based on the weight of available evidence, it is more likely than not that some portion or all of the gross DTAs will not be realized. The statutory valuation allowance adjustment will reduce the gross DTAs to the amount that is more likely than not to be realized (the adjusted gross deferred tax assets). See SSAP No. 10R, *Income Taxes—Revised, A Temporary Replacement of SSAP No.10*. SSAP No. 10R is effective for 2009 annual financial statements and 2010 interim and annual financial statements only. In the event subsequent deferred tax asset admission guidance is not adopted by the end of SSAP No. 10R's effective period, SSAP No. 10 will be reinstated as authoritative guidance for accounting and reporting of income taxes for SAP.	Provision made for temporary differences, net operating losses, and credit carryforwards under FASB ASC 740, *Income Taxes*.

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles**
Leases	All leases, except leveraged leases should be considered operating leases. See SSAP No. 22, *Leases*.	Classified as capital or operating according to the provisions of FASB ASC 840, *Leases*.
Liability for postretirement benefits other than pensions	An employer should account for its postretirement benefits for vested employees only, on an accrual basis. See SSAP No. 14, *Postretirement Benefits Other Than Pensions,* which adopted FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*, with some modifications.	Expected postretirement benefit obligations are recognized over the working life of employees; liability based on vested and nonvested benefits under FASB ASC 715, *Compensation—Retirement Benefits*.
Pension benefits	For defined benefit plans, reporting entities should adopt FASB ASC 715 with a modification to exclude nonvested employees and account for additional minimum pension liability. The excess of plan assets over obligations should be treated as a nonadmitted asset. Net plan obligations must be accrued irrespective of funding. For defined contribution plans, the reporting entity should expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting should be treated as prepaid expenses and should be nonadmitted. Contributions required after participants terminate or retire should be accrued and an expense should be recorded over the working lives of the participants. See SSAP No. 89, *Accounting for Pensions, A Replacement of SSAP No. 8*, which adopts FASB ASC 715, with some modifications.	Pension costs calculated based on the projected unit credit method under FASB ASC 715.

(continued)

	Codified Statutory Accounting Practices	*Generally Accepted Accounting Principles*[*]
Contract acquisition costs	Charged to expense when incurred. See SSAP No. 71, *Policy Acquisition Costs and Commissions*.	Deferred and amortized in relation to the revenue generated (premiums or estimated gross profit, as appropriate) if recoverable from such revenue. See FASB ASC 944.
Consolidation	Generally not applied given financial statement focus on presentation from a liquidity of assets standpoint for regulatory purposes. Majority-owned subsidiaries are not consolidated for individual entity statutory reporting. See SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88*.[‖]	Generally required in accordance with FASB ASC 810.

[*] Generally accepted accounting principles (U.S. GAAP) in this chart contains numerous references to both financial and nonfinancial assets and liabilities that are subject to fair value measurement. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value that applies broadly to financial and nonfinancial assets and liabilities and improves the consistency, comparability, and reliability of the measurements. The guidance in FASB ASC 820 applies under other accounting pronouncements that require or permit fair value measurements. Accordingly, FASB ASC 820 does not require any new fair value measurements but the application of it will change current practice. For further information, see www.fasb.org and chapter 5, "Investments."

[†] The National Association of Insurance Commissioners (NAIC) Financial Condition Committee had previously adopted a short term resolution for hybrid securities classification. At the Summer 2008 NAIC meeting, the NAIC decided not to adopt the short term "notching solution," but instead to adopt a 2007 report from the American Academy of Actuaries, and look for a long term solution to improve identification, classification, and accounting guidance for new structured investments. As of January 1, 2009, the notching solution expired, and hybrid securities should be reported in Schedule D with a separate line number and the annual statement note disclosure for these holdings would be eliminated. A definition of *hybrid securities* was also added to the investment schedules instructions. For additional specifics, see chapter 5, "Investments."

[‡] The NAIC adopted Statement of Statutory Accounting Principle (SSAP) No. 96, *Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*. Related party transactions are now required to be in the form of a written agreement that specifies a due date. Amounts receivable from related parties over 90 days past due from the due date or if the due date is not specified in the agreement, are now nonadmitted.

[‖] SSAP No. 96 deals with the application of the 90-day admissibility rule with respect to intercompany transactions. It amends SSAP No. 25, *Accounting for and Disclosure about Transactions with Affiliates and Other Related Parties*, to include certain criteria for the admissibility of the related party receivable.

Exhibit 1-1

Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis [1,2]

Question. Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a *statutory basis*) in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the National Association of Insurance Commissioners' (NAIC's) codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised manual. The revised manual contains extensive disclosure requirements. As a result, after a state adopts the revised manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC annual statement instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate? [3]

Interpretation. Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to paragraph .04 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1). Paragraph .09 of AU section 623 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04."

AU section 623 paragraph .02 states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Question. What types of items or matters might be considered by auditors when evaluating whether informative disclosures are reasonably adequate?

Interpretation. AU section 623 paragraphs .09–.10 indicate that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. The provisions of the preamble of the revised manual that states, "GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC," do not negate the requirements of AU section 623 paragraph .10, which also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate."

Question. How does the auditor evaluate whether "similar informative disclosures" are appropriate for

a. items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?

b. items and transactions that are accounted for differently under a statutory basis than under GAAP?

c. items and transactions that are accounted for differently under requirements of the state of domicile than under the revised manual?

Interpretation. Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised manual specifically states the NAIC Codification rejected the GAAP disclosures.[4] Disclosures should also include those required by the revised manual.

Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under the statutory basis than under GAAP, but in accordance with the revised manual, should be the disclosures required by the revised manual.

If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. Other matters could be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

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[1] Reprinted from AU section 9623, *Special Reports: Auditing Interpretations of Section 623* (AICPA, *Professional Standards*, vol. 1).

[2] This exhibit reflects the amendments to AICPA Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," as amended, of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1,

AU sec. 9623 par. .60–.77), as made by Statement of Position 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, effective December 15, 2001, and by the amendments made by the Auditing Standards Board, effective January 2005, subsequent to the Public Company Accounting Oversight Board adoption of the AICPA standards as interim, on April 16, 2003.

[3] It is possible for one of three different situations to occur: the state adopted the revised manual without significant departures, adopted the revised manual with significant departures, or has not yet adopted the revised manual.

[4] The provisions of the revised manual preamble that state, "GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC," or any other explicit rejection of a generally accepted accounting principles disclosure does not negate the requirements of paragraph .10 of AU section 623. (Note that NAIC Interpretation 04-1, *Applicability of New GAAP Disclosures Prior to NAIC Consideration*, is consistent with the revised manual.)

Chapter 2

Audit Considerations

Introduction

2.01 In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This section of the guide provides guidance, primarily on the application of the standards of fieldwork. Specifically, this section provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and general auditing considerations for audits of financial statements of property and liability insurance entities.

Scope of the Audit Engagement

General Considerations

2.02 AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), states the auditor should establish an understanding with the property and liability insurance entity regarding the services to be performed for each engagement. This understanding should be documented through a written communication with the property and liability insurance entity in the form of an engagement letter. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and limitations of the engagement. The nature, timing, and extent of audit procedures to be performed and the kind of reports to be issued are based on the scope of the audit services requested by the property and liability insurance entity.

> *Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB)*
>
> Paragraphs .05–.07 of AU section 310, *Appointment of the Independent Auditor* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), provides requirements and guidance for auditors establishing an understanding with the client regarding services to be performed when performing an audit of financial statements only, or when performing an integrated audit of financial statements and internal control over financial reporting.

2.03 In defining the scope of audit services, the auditor may consider matters relating to specific reporting responsibilities of the engagement including, but not limited to, the following:

a. The legal structure or organization of the insurance entity and the number and kind of entities that need separate reports on statutory accounting principles or generally accepted accounting principles (GAAP) financial statements (or both), or that need consolidated GAAP statements *b.* Regulatory reporting and filing requirements for local, state, and federal regulatory authorities

c. Reporting requirements—of a foreign parent or subsidiaries—such as those for which requirements and guidance are provided in AU section 534, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, vol. 1), for the auditor practicing in the United States, who is engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles that are generally accepted in another country for use outside the United States

PCAOB Integrated Audit of Financial Statements and Internal Control Over Financial Reporting[1]

2.04 Many property and liability insurance entities are public issuers; the scope requirements for audits of issuers have been expanded. As described in paragraph 2.112, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission (SEC) requires a PCAOB registered public accounting firm's attestation report on management's assessment of the entity's internal control over financial reporting. PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards),[2] establishes requirements and provides directions that apply when an auditor is engaged to audit both an entity's financial statements and management's assessment of the effectiveness of internal control over financial reporting.

2.05 More specifically, for integrated audits, paragraph 3 of PCAOB Auditing Standard No. 5 states that "the auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the entity's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment. The auditor should integrate the audit of internal control over financial statements with the audit of the financial statements. Maintaining effective internal control over financial reporting means that no material weaknesses exist; therefore, the objective of the audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist as of the date specified in management's assessment."

2.06 PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes requirements and provides directions that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting

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[1] This service is referred to as an integrated audit throughout the guide. Certain areas of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), guidance that corresponds to guide topics discussed is indicated but is not inclusive.

[2] PCAOB Auditing Standard No. 5 is effective for fiscal years ending on or after November 15, 2007.

continues to exist as of a date specified by management. The engagement described by the standard is voluntary and the standards of the PCAOB do not require an auditor to undertake an engagement to report on whether a previously reported material weakness continues to exist.

2.07 PCAOB Auditing Standard No. 4 amended paragraph .04 of AT section 101, *Attest Engagements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), to clarify that PCAOB Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than an entity's internal use.

Planning and Other Auditing Considerations

2.08 The objective of an audit of a property and liability insurance entity's financial statements is to express an opinion on whether they present fairly, in all material respects, the entity's financial position, results of operations, and cash flows in conformity with GAAP or an other comprehensive basis of accounting. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to property and liability insurance entities.

Audit Planning

2.09 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311 (AICPA, *Professional Standards*, vol. 1) establishes standards and guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

2.10 Paragraph .03 of AU section 311 (AICPA, *Professional Standards*, vol. 1) states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Paragraph .01 of AU section 311, *Planning and Supervision* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that

when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 9 of PCAOB Auditing Standard No. 5 regarding planning considerations, in addition to the planning considerations set forth in AU section 311.

Audit Risk

2.11 Paragraph .12 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

2.12 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) detection risk (see appendix A of this guide for further discussion of these components including, how these components relate to loss reserves). Paragraph .23 of AU section 312 (AICPA, *Professional Standards*, vol. 1) states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis to design and perform further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be "at the maximum." This assessment may be in qualitative terms such as high, medium, and low or in quantitative terms such as percentages.

2.13 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Specific Audit Risk Factors

2.14 Experience has demonstrated that audit risk may be greater in certain operating areas than in others. Significant transaction cycles of property and liability insurance entities include the premium cycle, the claims cycle, the reinsurance cycle, and the investment cycle. Risk factors specific to these cycles, as well as other audit risk factors, are described in appendix A to this guide. Although the summary of the risk potential in these operating areas is not all-inclusive, the summary does present major areas of recommended concentration in determining the nature and extent of audit procedures described in other chapters of this guide. The auditor's preliminary conclusions regarding the degree of audit risk may be modified by the results of audit work performed. The procedures described throughout this guide for each major operating cycle focus on the preceding overall risks as well as on other kinds of audit risks, and the auditor may refer to those chapters for additional guidance.

Planning Materiality

2.15 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

2.16 In accordance with paragraph .27 of AU section 312 (AICPA, *Professional Standards*, vol. 1), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. Examples of benchmarks for property and liability insurance entities include the balance or account in question as (*a*) percentage of surplus, (*b*) percentage of after tax income, and (*c*) percentage of total assets.

2.17 As stated in paragraph .30 of AU section 312 (AICPA, *Professional Standards*, vol. 1), once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited. Materiality is determined based on the auditor's understanding of the user needs and expectations. User expectations may differ based on the degree of inherent uncertainty associated with the measurement of particular items in the financial statements, among other considerations. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (for example, provisions for insurance claims in the case of an insurance entity) may influence the user's assessment of materiality. However, for audit purposes, this factor does not cause the auditor to follow different procedures for planning or evaluating misstatements than those outlined for other entities.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Paragraph .03 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 20 of PCAOB Auditing Standard No. 5 regarding materiality considerations.

Tolerable Misstatement

2.18 The initial determination of materiality is made for the financial statement taken as a whole. Depending on the circumstances, the auditor also may determine materiality levels for particular items, as described in AU section 312 paragraph .31 (AICPA, *Professional Standards*, vol. 1), that are lesser than the materiality level determined for the financial statements taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than these materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. AU section 312 (AICPA, *Professional Standards*, vol. 1) paragraph .34 defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

2.19 As indicated, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

2.20 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 (AICPA, *Professional Standards*, vol. 1) provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Use of Assertions in Obtaining Audit Evidence

2.21 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories.

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.

Categories of Assertions—continued

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understand-ability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

2.22 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

2.23 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows:

> The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

2.24 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1). See paragraphs 2.99–.102 for additional guidance pertaining to AU section 316 (AICPA, *Professional Standards*, vol. 1).

2.25 This section addresses the unique aspects of property and liability insurance entities that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

Risk Assessment Procedures

2.26 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. AU section 326 paragraph .21 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

2.27 In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Discussion Among the Audit Team

2.28 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 (AICPA, *Professional Standards*, vol. 1) to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Entity and Its Environment

2.29 AU section 314 states that the auditor must obtain an understanding of the entity and its environment, including its internal control. In accordance with AU section 314 paragraph .04, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (*a*) to assess risks of material misstatement of the financial statements and (*b*) to design and perform further audit procedures (tests of controls and substantive tests).

2.30 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies (see the following section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (*a*)–(*d*).

2.31 In order to obtain a general understanding of the industry, the auditor may refer to chapter 1 of this guide, which discusses the nature of the property and liability insurance business and many characteristics of operations in the industry. The bibliography at the end of this guide provides sources for additional information on the industry. Although conditions will vary from entity to entity, the independent auditor may consider the conditions discussed in the Audit Risk Alert *Insurance Industry Developments* for the current year.

2.32 Discussed in the following paragraphs are some unique characteristics of property and liability insurance entities that the auditor may consider when obtaining an understanding of the entity and its environment in order to assess the risks of material misstatement.

Combined and Operating Ratios

2.33 The profitability of an insurance entity on a statutory basis is generally gauged by combined ratio and its operating ratio. The combined ratio is the sum of its loss ratio (total incurred losses and loss adjustment expenses expressed as a percent of earned premiums), its expense ratio (total underwriting expenses incurred less other income to written premiums), and its dividend ratio (policyholder dividends expressed as a percent of earned premiums). The operating ratio is the combined ratio less the ratio of investment income, to earned premiums.

2.34 The auditor may consider using the combined and operating ratios—both for the industry and for the insurance entity whose financial statements are being audited—in evaluating the risk of material misstatement at the financial statement level. For example, these ratios may provide information about the entity's profitability relative to the industry and about the economic conditions prevalent in the industry as a whole.

Risk-Based Capital

2.35 Because of the importance of risk-based capital (RBC) to property and liability insurance enterprises, the auditor may consider RBC when assessing the risks of material misstatement. The auditor may obtain and review the client's RBC reports to further his or her understanding of the RBC requirements for preparing such reports and the actual regulations associated with RBC. For more information on RBC, refer to the section titled "The Auditor's Consideration of Regulatory Risk-Based Capital for Property and Liability Insurance Enterprises."

National Association of Insurance Commissioners Insurance Regulatory Information System

2.36 Many insurance laws and regulations address insurance entities' financial solvency, and insurance departments consequently monitor reports, operating procedures, investment practices, and other activities of insurance entities. One of the main purposes of the monitoring system is to detect, at an early stage, entities that are insolvent or may become insolvent.

2.37 To assist state insurance departments in monitoring the financial condition of property and liability insurance entities, the National Association of Insurance Commissioners (NAIC) Insurance Regulatory Information System (IRIS) was developed by a committee of state insurance department regulators. It is intended to assist state insurance departments in identifying insurance entities whose financial condition warrants close surveillance. The system is based on 12 tests for property and liability insurance entities. The tests are based on studies of financially troubled entities compared to financially sound entities. Usual ranges have been established under each of the tests for a property and liability entity, but the ranges may be adjusted to reflect changing economic conditions. The results of the tests of all entities are compared, and those entities with three or more results outside of the usual range are given a priority classification indicating that a close review of the entity be undertaken. In addition, a regulatory team annually reviews the results and recommends regulatory attention if needed. One or more results outside the usual range do not necessarily indicate that an entity is in unstable financial condition, but the entity may need to explain the circumstances causing the unusual results. Annually, the NAIC publishes a booklet titled *NAIC Financial Solvency Tools—Insurance Regulatory Information System (IRIS)*, which explains the IRIS ratios in detail. (Each of the individual ratios and the acceptable results is briefly described in appendix E.) The auditor may consider IRIS test results when performing analytical procedures in the planning stage of an audit. IRIS ratios are no longer required to be filed separately to NAIC due to current electronic filing requirements of NAIC annual statements.

2.38 The NAIC has also established RBC standards for the property and liability insurance industry. RBC provides minimum means of setting the capital standards for insurance entities to support their overall business operations in light of their size and risk profile. An entity's RBC is calculated by applying factors to various asset, premium, and reserve items, where the factor is higher for those items with greater underlying risk and lower for less risky items. RBC standards will be used by regulators to set in motion appropriate regulatory actions relating to insurers which show signs of weak or deteriorating conditions. They also provide an additional standard for minimum surplus, below which entities would be placed in conservatorship.

NAIC Profitability Reports

2.39 The annual statement and supplemental exhibits are the sources of data for the NAIC Profitability Reports. The Overall Profitability Report develops 6 rates of return: 2 on sales (earned premium), 2 on net worth, and 2 on assets. The Overall Profitability Report by Company was developed by the NAIC in 1971. The stated purpose of the report is to establish uniform standards for measuring the profitability of property-liability insurance entities (individually and for entities collectively) on a basis that will facilitate comparisons with other businesses and industries. Certain assumptions are made and the data reported in insurers' annual statements are adjusted by formulas adopted by the NAIC to estimate a "going-concern" basis. Annually, the NAIC publishes a booklet titled *Using the NAIC Profitability Results*. This booklet explains in detail the rate-of-return calculations for the Overall Profitability Report by company. In addition to the NAIC, several states have developed their own systems of early-warning tests.

2.40 Other industry sources useful in the preliminary assessment of risk evaluation include annual and quarterly statements filed with regulatory authorities, regulatory examination reports, IRS examination reports, and communications with regulatory authorities.

Understanding of Internal Control[3]

2.41 AU section 314 states that the auditor must obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

a. evaluate the design of controls relevant to an audit of financial statements.

b. determine whether they have been implemented.

2.42 The auditor should use the understanding to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

[3] For additional nonauthoritative guidance pertaining to internal control and the risk assessment standards (Statements on Auditing Standards Nos. 104–111), refer to Technical Questions and Answers (TIS) sections 8200.05–.16, (AICPA, *Technical Practice Aids*), issued in March and April 2008.

2.43 Obtaining an understanding of the entity and its environment, including internal control, is a continuous dynamic process of gathering, updating, and analyzing information throughout the audit. The objective of obtaining an understanding of controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

2.44 AU section 314 paragraph .41 defines *internal control* as "a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of the following 5 interrelated components:

a. Control environment

b. Risk assessment

c. Control activities

d. Information and communication systems

e. Monitoring

Refer to paragraphs .67–.101 of AU section 314 for a detailed discussion of the internal control components.

Use of Information Technology[4]

2.45 Because of large volumes of premium and claims transactions and the need to maintain accountability for individual policies, most property and liability insurance entities use IT systems to maintain statistical and accounting records. Typically, policy and agent master files are maintained on computerized systems, and entities may use telecommunications, including direct access capability by agents and insureds, integrated premium and claims data bases, and processing systems that lack traditional audit trails. Many entities have made significant investments in computer hardware and software and large staffs of programmers, systems analysts, and technicians to maintain day-to-day operations. Dependence on IT systems and controls may affect control risk, particularly for larger multiple-line insurance entities.

2.46 As stated in paragraph .57 of AU section 314, an entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units[5] or business functions. In obtaining an understanding of internal control sufficient to assess the risk of material misstatement, the auditor considers how an entity's use of IT and manual procedures may affect

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[4] AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides standards and guidance to auditors in auditing the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically.

[5] When performing an audit in accordance with PCAOB standards, refer to appendix B, "Special Topics," of PCAOB Auditing Standard No. 5 for discussion of considerations when an entity has multiple locations or business units.

controls relevant to the audit. The use of IT also affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported. In a manual system, an entity uses manual procedures and records in paper format. Controls in such a system also are manual and should include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, authorize, record, process, and report transactions, in which case records in electronic format replace such paper documents as applications, claims payment authorizations, underwriting reviews and approvals, and related accounting records. Controls in systems that use IT consist of a combination of automated controls and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT. Insurance entities have been leading users of advanced IT methods. Consequently, the control issues involving IT have received considerable attention within the industry. The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls, including effective general controls upon which application controls depend. Such general controls may include

- *organization and operations controls*:
  - — IT department and user department functions should be segregated.
  - — Guidelines for the general authorization of executing transactions should be provided. For example, the IT department should be prohibited from initiating or authorizing transactions.
  - — Functions within the IT department should be segregated.
- *systems development and documentation controls*:
  - — The procedures for system design, including the acquisition of software packages, should encourage active participation by representatives of the users and, as appropriate, the accounting department and internal auditors.
  - — Each system should have written specifications that are reviewed and approved by an appropriate level of management and applicable user departments.
  - — System testing should be a joint effort of users and IT personnel and should include both the manual and computerized phases of the system.
  - — Final approval should be obtained prior to placing a new system into operation.

- — All master file and transaction file conversion should be controlled to prevent unauthorized changes and to provide accurate and complete results.
- — After a new system has been placed in operation, all program changes should be approved before implementation to determine whether they have been authorized, tested, and documented.
- — Management should document the system and establish formal procedures to define the system at appropriate levels of detail.

- *hardware and systems software controls*:
  - — The control features inherent in the computer hardware, operating system, and other supporting software should be used to the maximum possible extent to provide control over operations and to detect and report hardware malfunctions.
  - — Systems software should be subjected to the same control activities as those applied to installation of and changes to application programs.
- *access controls*:
  - — Access to program documentation should be limited to those persons who need access to perform their duties.
  - — Access to data files and programs should be limited to those individuals authorized to process or maintain particular systems.
  - — Access to computer hardware should be limited to authorized individuals.
- *data and procedural controls*:
  - — A control function should be responsible for receiving all data to be processed, for ensuring that all data are recorded, for following up on errors detected during processing to ensure that the transactions are corrected and resubmitted by the proper party, and for verifying the proper distribution of output.
  - — A written manual of systems and procedures should be prepared for all computer operations and should provide for management's general or specific authorization to process transactions.
  - — Internal auditors or some other independent group within an organization should review and evaluate proposed systems at critical stages of development.
  - — On a continuing basis, internal auditors or some other independent group within an organization should review and test computer processing activities.

2.47 The sophistication of insurance IT systems is often an element of competition regarding an entity's ability to service accounts. The IT operations are characterized by one or several large installations, extensive use of telecommunications equipment, including some direct-access capability by independent agents and insureds, large premium and claims data bases, some of which are integrated, and operating systems and applications that lack visible audit trails.

2.48 This guide does not address the major effects of IT on an audit. Guidance on auditing records for which IT is a significant factor is contained in the following:

a. AU section 314

b. AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1)[6]

c. AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

2.49 As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

2.50 AU section 314 paragraph .102 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.

b. relate the identified risks to what can go wrong at the relevant assertion level.

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

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[6] The Audit Guide *Service Organizations: Applying SAS No. 70* includes illustrative control objectives as well as interpretations that address responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The guide also clarifies that the use of a service auditor's report is restricted to existing customers and is not meant for potential customers. Additionally, AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), expands subsequent event guidance with respect to audit responsibilities and management representations. For audits performed in accordance with PCAOB auditing standards, the PCAOB staff has issued a series of nonauthoritative Q&As on various topics. Questions 24–26 and 29 at www.pcaobus.org pertain to service organizations.

2.51 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

2.52 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

2.53 AU section 318 provides guidance about implementing the third standard of field work, as follows:

> The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

2.54 To reduce audit risk to an acceptably low level, the auditor (*a*) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (*b*) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

Overall Responses

2.55 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

2.56 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing, and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level. In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often may determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach. Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

2.57 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level as discussed in AU section 314 paragraphs .117–.120.

2.58 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

2.59 Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

2.60 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

Evaluating Misstatements

2.61 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. AU section 312 (AICPA, *Professional Standards*, vol. 1) paragraph .42 states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management. AU section 312 (AICPA, *Professional Standards*, vol. 1) further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration should include, among other things, the effect of misstatements related to prior periods.

2.62 For detailed guidance on evaluating audit findings and audit evidence, refer to AU sections 312 (AICPA, *Professional Standards*, vol. 1) and 326, respectively.

Audit Documentation

2.63 As stated in paragraph .03 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), the auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusion reached. Audit documentation

a. provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with GAAS.

b. provides that principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

2.64 Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

2.65 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or working papers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.

2.66 Audit documentation includes, for example, audit plans, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.

2.67 AU section 339 provides requirements and guidance on the form, content, and extent of audit documentation. It also discusses how to document significant finding, or issues. This section states that the auditor should record the preparer and reviewer of the audit work and the date such work was prepared and reviewed. In addition, it provides guidance on audit documentation of specific items tested, documentation when there is a departure from Statements on Auditing Standards, revisions to audit documentation made after the date of the auditor's report, and the ownership and confidentiality of audit documentation. See AU section 339 for specific guidance.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes the documentation requirements for audits performed in accordance with PCAOB standards.

Consideration of the Work of Internal Auditors

2.68 In audits of property and liability insurance entities, auditors may consider using the work of internal auditors in areas including, but not limited to, the following:

- Testing IT general and application controls
- Testing premiums and claims processing
- Testing the integrity of the databases underlying the loss-reserving systems

AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), establishes requirements and guidance for an auditor using the work of, or receiving direct assistance from, the entity's internal auditors.

> *Considerations for Integrated Audits Performed in Accordance with PCAOB Standards*
>
> Paragraphs 16–19 of PCAOB Auditing Standard No. 5 establish requirements and provide direction for auditors using the work of others to reduce the work that otherwise would have been performed by the auditor to test controls.

Communications by Successor Auditors[7]

2.69 AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance on communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It also provides requirements and guidance on communications when possible misstatements are discovered in financial statements.

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[7] Additionally, the PCAOB has issued a Staff Q&A titled *Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor* available at www.pcaobus.org.

Communication of Matters Related to Internal Control[8]

2.70 For audits conducted under GAAS, AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on evaluating and communicating matters related to an entity's internal control over financial reporting identified during an audit of financial statements. It is contemplated that communication would generally be with the audit committee or others charged with governance with an equivalent level of authority and responsibility (such as the board of directors or trustees, an owner in an owner-managed entity, or in organizations that do not have an audit committee with others who may have engaged the auditor). AU section 325 (AICPA, *Professional Standards*, vol. 1) provides that the communication should state that it is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made. For integrated audits performed in accordance with PCAOB standards, additional guidance is provided in paragraphs 78–84 of PCAOB Auditing Standard No. 5.

2.71 AU section 325 (AICPA, *Professional Standards*, vol. 1), requires that deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

2.72 For audits performed in accordance with PCAOB standards, AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and paragraphs 78–84 of Auditing Standard No. 5 provide guidance on identifying and reporting deficiencies that relate to an entity's internal control for audits of financial statements only and integrated audits, respectively. The auditor must communicate in writing to management and the audit committee control deficiencies that are either significant deficiencies or material weaknesses as defined in paragraphs .02–.03 and .09–.10 of AU section 325. For integrated audits, all deficiencies in internal control with a lesser magnitude than a significant deficiency must be reported in writing to management and the audit committee notified when communication is made.

2.73 Written communications should be best made prior to the issuance of the auditor's report on the financial statements for nonissuers and should be made prior to the issuance of the auditor's report for issuers. The auditor's

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[8] The National Association of Insurance Commissioners (NAIC) adopted revisions to the Model Regulation in June of 2006. Changes to the Model Audit Rule considered certain provisions of the Sarbanes-Oxley Act of 2002. Changed provisions included requiring management to prepare a report on internal control over financial reporting per Section 16 of the revised Model Audit rule effective December 31, 2010. This is required for every insurer required to file an audited financial report that has annual direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, of $500 million or more.

communications should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, according to AU section 325 paragraph .04 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) and paragraph 78 of Auditing Standard No. 5. The audit committee or other proper equivalent level of authority is defined in AU section 325 paragraph .04 and footnote 8 in paragraph 9 of Auditing Standard No. 5. For additional information on internal control communications, see the applicable standard.

2.74 Additionally, among other matters, Section 404 of the Sarbanes-Oxley Act of 2002 requires a report on management's assessment of internal control over financial reporting of the public accounting firm to be included in an issuer's annual report.[*] This report may or may not be combined with the audit opinion. Refer to paragraphs C16–C17 of appendix C, *Special Reporting Situations*, of Auditing Standard No. 5, which provides direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in filing under federal securities statutes. Finally, the insurance commissioner of the state of domicile requires that the auditor prepare for the client a written report describing any significant internal control deficiencies and provide a description of remedial actions taken or proposed to correct those deficiencies.

Communication of Other Matters With Audit Committees[9, 10]

2.75 AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements regardless of an entity's governance structure or size. Particular considerations apply where all of those charged with governance are involved in managing an entity.

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[*] The Securities and Exchange Commission (SEC) issued Final Rule 33-8934, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*. Under the amendments, a nonaccelerated filer will be required to file the auditor's attestation report on internal control over financial reporting when it files an annual report for a fiscal year ending on or after December 15, 2009, which effectively extends the deadline by 12 months.

[9] PCAOB Release No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees*, provides rules for registered public accounting firms to provide certain information to audit committees in connection with seeking preapproval to provide nonprohibited tax services. For additional information, see chapter 7, "Taxes."

[10] PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), requires the registered public accounting firm to (*a*) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence; (*b*) discuss with the audit committee of the issuer the potential effects of any relationships that could affect independence if they are appointed as the issuer's auditor; and (*c*) document the substance of these discussions. These discussions should occur at least annually. The board also adjusted the implementation schedule for Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions became effective September 30, 2008.

Considerations for Audits Performed in Accordance with PCAOB Standards

AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), establishes requirements and provides direction for auditors when communicating certain matters to the audit committee.

2.76 AU section 380 paragraph .34 (AICPA, *Professional Standards*, vol. 1) states that the auditor should communicate with those charged with governance his or her views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.

2.77 AU section 380 paragraph .40 (AICPA, *Professional Standards*, vol. 1) states that the auditor should communicate with those charged with governance uncorrected misstatements and the effect that they may have on the opinion in the auditor's report, and request their correction. The auditor should communicate the effect that material uncorrected misstatements may have on the opinion in the auditor's report individually. Where there are a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the misstatements, rather than the details of each individual misstatement. Paragraph .41 of AU section 380 (AICPA, *Professional Standards*, vol. 1) states that auditors should discuss with those charged with governance the implications of a failure to correct known and likely misstatements, if any, based on qualitative and quantitative aspects of the misstatements, including possible implications in relation to future financial statements. Auditors should consider SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality* (Codification of Staff Accounting Bulletins, Topic 1—*Financial Statements*, Section M), when assessing the materiality of misstatements, at least for public entities.

2.78 SEC SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (Codification of Staff Accounting Bulletins, Topic 1—*Financial Statements*, Section N), provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements is considered in quantifying a current year misstatement. The SEC staff believes registrants should quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach, and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

2.79 If, in correcting an error in the current year, an error is material to the current year's income statement, the prior year financial statements should be corrected even though such a revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in the

SAB. Additional specifics on SAB No. 108 can be obtained at the issuance at www.sec.gov/interps/account/sab108.pdf.

Consideration of Fraud in a Financial Statement Audit

2.80 Risks are inherent in all audit engagements, including the possibility of fraudulent acts may cause a material misstatement of financial statements. AU section 316 (AICPA, *Professional Standards*, vol. 1) is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 (AICPA, *Professional Standards*, vol. 1) establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Paragraph .01 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 14–15 of PCAOB Auditing Standard No. 5 regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316.

2.81 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Additionally, three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

2.82 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[11]

2.83 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316 (AICPA, *Professional Standards*, vol. 1). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives or pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

2.84 Factors that may increase the risk of material misstatement due to fraud as a result of the items described in paragraph 2.82 include, but are not limited to, the following:

a. Internal factor: a significant portion of management compensation (that is, bonuses and stock options) is contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow. Incentives specific to the insurance industry may include

   i. pressures motivating the underwriting department to become more profitable.

   ii. the investment department is evaluated based upon investment yields.

   iii. management or reserving actuaries included in short-term profit-sharing plan or incentive compensation arrangements linked to net income or surplus.

b. External factor: a slow economy. Because insurers have such a large number of investments, equity market declines and reduced market interest rates will significantly lower investment returns. Such conditions could result in insurers looking to new investment vehicles to secure sufficient investment margins including derivatives, real estate, mortgage loans, and joint venture arrangements. Insurers should have controls in place to ensure adequate underwriting, due diligence, and accounting controls on new investments. Pressure exists to have investment results improve overall results in periods where underwriting operation is underperforming.

c. Internal factor: significant dependency on information systems for support in day-to-day operations, and a lack of controls regarding access to information systems. For example, a risk of loss exists from employees who have access to the claim system. They could make unauthorized changes to policyholder account balances, ceded reinsurance account balances, or third party claim payments. They

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[11] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314 to discuss the potential of the risks of material misstatement.

could also approve fraudulent claims payable to themselves or excess payments to others (such as auto repair centers).

d. Internal factor: failure by management to communicate and demonstrate an appropriate attitude regarding internal control, as well as management's ability to override internal controls in financial reporting related to

   i. numerous manual adjustments to determine amounts recorded in financial statements (that is, accrual entries booked to a cash-basis ledger or statutory-to-U.S. GAAP adjustments).

   ii. correcting entries or adjustments made by management, particularly at or near year-end.

   iii. adjusting entries made directly to the financial statements.

Insurance Industry Fraud Risk Factors

2.85 Fraud risk factors relevant to fraudulent financial reporting and misappropriation of assets are described in tables 2-1 and 2-2, respectively. The risk factors are further classified based on the 3 conditions generally present when material misstatements due to fraud occur: incentives and pressures, opportunities, and attitudes and rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may consider additional or different risk factors. Also, the order of the examples of risk factors provided in tables 2-1 and 2-2 is not intended to reflect their relative importance or frequency of occurrence. Finally, some of the risk factors related to misstatements arising from fraudulent financial reporting may also be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist.

2.86 An auditor's interest specifically relates to fraudulent acts that may cause a material misstatement of the financial statements. Some of the following factors and conditions are present in insurance entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditor assesses whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements. The industry-specific fraud risk factors that follow include interpretations of some of the AU section 316 (AICPA, *Professional Standards*, vol. 1) example risk factors tailored to the insurance industry. Each section supplements, but does not replace, the example risk factors included in AU section 316 (AICPA, *Professional Standards*, vol. 1). Tables 2-1 and 2-2 are not meant to be inclusive.

Table 2-1

Fraud Risk Factors—Fraudulent Financial Reporting

Incentive/ Pressure Financial stability or profitability is threatened by economic, industry, or entity operating conditions such as:	*a*. New accounting, statutory, or regulatory requirements.	1. New criteria used by rating agencies to assign ratings to insurers. 2. Impact of statutory accounting principles. 3. Demutualization. 4. Changes in risk-based capital requirements. 5. Changes in consolidation criteria (for example, special purpose entities).
	b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.	1. Rapidly changing distribution network results in different sales channels without adequate controls (for example, possible use of the Internet). 2. Changes in interest rates or in the fair value of invested securities may have a significant impact on the financial results of many insurance entities.
	c. Rapid growth or unusual profitability especially compared to that of other entities in the same industry.	1. Unusual and considerable increases in the number of policyholders over a short period of time. 2. Loss ratios significantly different from entities offering similar insurance coverages. 3. Significant concentrations of policyholders in the same geographic region causing greater exposure to catastrophe. 4. Unusual increases in the number of policies in mature lines of business, potentially indicating inadequate pricing to gain business from competitors.
	d. Emerging trends in claims settlement and litigation.	1. Identification of emerging new classes of claims. 2. Plaintiffs expanded theory of liability. 3. Court coverage decisions and judicial interpretations. 4. Expanded liability due to changes in legislation such as with asbestos litigation reform.

Fraud Risk Factors—Fraudulent Financial Reporting—continued

	e. High degree of competition or market saturation, accompanied by declining margins.	1. Rapid development of new products reacting to the market environment without adequate review of long-term strategies. 2. Volatility of earnings due to market environment that could cause an entity to manipulate earnings. 3. Large inflow of additional capital putting pricing pressure on current insurers.
	f. Volatility of earnings due to catastrophic losses could cause the entity to manipulate earnings in other areas.	1. Overstatement of adjustable features on reinsurance contracts such as profit sharing or sliding scale commissions in light of increasing ceded losses.
Incentive/ Pressure Excess pressure for management to meet the requirements or expectations of third parties due to the following:	*a*. Pressure to meet profitability or trend expectations of investment analysts.	
	b. Pressure from rating agencies to maintain or improve ratings.	1. Favorable trends not in line with the industry. 2. Pressures exerted over internal or external valuation actuaries. 3. Smoothing of earnings through changes to IBNR reserves.
	c. Pressure to meet risk-based capital requirements.	1. Close to triggering regulatory actions in prior periods based on declining surplus and thus affecting risk-based capital. 2. Failure to achieve forecasts provided to regulators.
Opportunity The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from:	*a*. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.	1. Unusual or complex intercompany reinsurance transactions. 2. Transactions entered into with affiliates, the impact of which is to increase statutory surplus. 3. Complex or inconsistent, or both, expense allocation agreements.

(continued)

Fraud Risk Factors—Fraudulent Financial Reporting—continued

b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.	1. Estimates for loss and loss adjustment expenses, reinsurance recoverables, deferred acquisitions costs, reserves, recoverability of net deferred tax assets, and others based on unusually subjective judgments. 2. Significant purchases and sales of securities that do not have an active market, which could indicate "parking losses." 3. Aggressive policies related to revenue recognition for administrative-service type contracts. 4. Improper classification of normal operating losses as "catastrophe-related" in financial reporting (for example, management discussion and analysis, footnote disclosure). Also, the diversion of an insurer's resources in dealing with a catastrophe could put a strain on internal controls.
c. Significant, unusual, or highly complex transactions, especially those close to period end, that pose difficult "substance over form" questions.	1. High yields on investments that appear to be low risk. 2. Transactions that "convert" nonadmitted assets to admitted assets. 3. Numerous and complex off-balance-sheet financing transactions. 4. Reinsurance transactions that embody loss assumptions that are very different from industry or historical trends in order to pass the "transfer of risk" rules. 5. Transactions that "convert" realized capital gains and losses to ordinary income or vice versa. 6. Significant closing journal entries for insurers that maintain their books on a statutory basis of accounting, which results in posting several statutory-to-GAAP adjusting entries. 7. Significant or unusual amount of quarter-end or year-end manual entries posted after consolidation.

Fraud Risk Factors—Fraudulent Financial Reporting—continued

		8. Absence of a review process for estimates of the value of closely held securities. 9. Agreements accounted for as reinsurance transactions that do not transfer risk.
Opportunity Ineffective monitoring of management due to the following:	*a*. Domination of the board of directors because it is composed primarily of an entity's close business partners (for example, agents, bankers, and lawyers).	1. Resignation of independent members.
Opportunity There is a complex organizational structure as evidenced by the following:	*a*. Significant transactions included in noninsurance affiliates with the sole purpose of excluding such activity from the statutory-basis financial statements filed with insurance regulators.	1. Use of related party management agreements. 2. Significant due to or due from between insurance entity and its affiliates.
Opportunity Internal control components are deficient as a result of:	*a*. Information systems which cannot account for complex features of insurance policies issued (for example, policies with complex deductible features) or reinsurance policies (for example, adjustable features).	
Attitude/ Rationalization Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend or statutory capital position.	*a*. Risk transfer criteria for reinsurance transactions are rarely met.	1. Use of contracts with structured payout patterns. 2. Inclusion of loss corridors within reinsurance agreements. 3. Adjustable features that could have a material effect on cash flows between the ceding and assuming entities (for example, profit sharing, sliding scale commissions, adjustable coverage).

(continued)

Fraud Risk Factors—Fraudulent Financial Reporting—continued

	b. Use of discretionary reserves to manipulate earnings.	1. Bulk reserves not included in the valuation actuary's loss reserve opinion. 2. Catastrophe reserves.
Attitude/ Rationalization A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.	*a*. Lack of board or management oversight of critical processes.	1. Underwriting-control risk, price risk. 2. IT systems or resources to effectively administer complex insurance or reinsurance contract provisions. 3. Monitoring of creditworthiness of reinsurers. 4. Suspense account clearance. 5. Treasury-securities/ derivative valuation (selection of models, methodologies, and assumptions). 6. Establishment of loss and loss adjustment expense reserves. 7. Investment decisions. 8. Understanding of critical accounting policies and significant estimates. 9. Agents or third party administrators with underwriting or claims settling authority.
	b. No business risk management responsibility or function.	
	c. No accounting policy responsibility or function.	
	d. Management's inattention to establish independent reporting lines for key assurance functions (for example, internal audit and quality control reviews of claims and underwriting).	
	e. Lack of insurance-industry or finance experience on the audit committee.	

Fraud Risk Factors—Fraudulent Financial Reporting—continued

Attitude/ Rationalization Management displaying a significant disregard for regulatory authorities.	*a*. Existence of a regulatory enforcement action. *b*. Prior examination findings not addressed or inadequately addressed. *c*. Mandated restatements of regulatory financial reports due to inappropriate accounting treatment. *d*. Assessment of market conduct fines.	
Attitude/ Rationalization A strained relationship between management and the current or predecessor auditor, as exhibited by the following:	*a*. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters such as the reasonableness of sensitive estimates (for example, loss and loss adjustment expense reserves, allowances for uncollectible reinsurance, and other amounts). *b*. Issuance of reportable condition or material weakness letters. *c*. Failure of management to address reportable condition or material weakness issues on a timely basis.	1. Internal or external auditors not allowed to report directly to the board of directors.
Attitude/ Rationalization Nonfinancial management's excessive participation in or preoccupation with the selection of the accounting principles or the determination of significant estimates.	*a*. Lack of management to establish controls over accounting policy issues.	

Table 2-2

Fraud Risk Factors—Misappropriation of Assets

Incentive/ Pressure Adverse relationships between the entity and employees with authority over cash and assets could motivate employees to misappropriate those assets.	*a*. History of workforce reductions.	1. For example, combining regional claims offices.
	b. Dissatisfaction with compensation.	1. Inequality in pay scale. 2. Unachievable incentive compensation goals.
Opportunity Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation, for example, opportunities to misappropriate assets increase when there are the following factors:	*a*. Significant activity and balances present in suspense accounts. *b*. Large volume premium checks received by the insurance entity rather than being sent to a lock box. *c*. Premiums are not directly remitted to the insurer but are instead collected by the agent.	
Opportunity Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because of the following factors:	*a*. Inadequate segregation of duties or independent checks.	1. Lack of rotation or review of claim adjusters on long-term claims. 2. Custodial reconciliations performed by an individual who records the amount to the ledger. 3. Bank reconciliations performed by individual with access to cash receipts.

Fraud Risk Factors—Misappropriation of Assets—continued

	b. Inadequate management oversight of employees responsible for assets.	1. Lack of adequate monitoring of underwriting policies and procedures. 2. Lack of management review or control processes over year-end or month-end transactions. 3. Extensive use of managing general agents with little or no supervision by management. 4. Lack of internal audit or claim quality review functions. 5. Inadequate payment approval process. 6. Lack of review or inadequate controls over system overrides (for example, claim payments and commissions). 7. Lack of strong custodial controls over cash/investments.
	c. Large volume of duplicate claims processed.	
	d. Large volume of claims paid to post office boxes.	1. No controls to ensure that claim adjustment payments are made only to authorized vendors.
	e. Large volume of claims paid to the same claimant.	1. No monitoring or enforcement of claims settlement authorities.
	f. Claims paid to employees.	
Attitude/ Rationalization Failure to report all instances of fraud to the audit committee.		
Attitude/ Rationalization Failure to properly staff internal audit and other (claims/ underwriting) quality control functions.		

(continued)

Fraud Risk Factors—Misappropriation of Assets—continued

Attitude/ Rationalization
Poor relationships between management, employees, and agents that may appear to justify misappropriations of assets.

Attitude/ Rationalization
Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

2.87 AU section 314 establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risks of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in AU section 316 (AICPA, *Professional Standards*, vol. 1) paragraphs .35–.42) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed (See AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraphs .20–.27)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit (See AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraphs .28–.30)

c. Consider whether one or more fraud risk factors exist (See AU section 316 (AICPA, *Professional Standards*, vol. 1) paragraphs .31–.33, the appendix to AU section 316 (AICPA, *Professional Standards*, vol. 1), and in this chapter see, tables 2-1 and 2-2 and paragraphs 2.84 and 2.87)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud (See AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraph .34)

In planning the audit, the property and liability insurance auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. Measurements and fluctuations indicative of potential fraudulent practice may include the following:

- Changes in loss ratios that differ from changes experienced by the industry for a given line of business
- Changes in the relationships between unearned premium reserve and earned premiums
- Deferred acquisition costs as a percentage of unearned premiums
- Agents' balances as a percentage of premiums
- Significant fluctuations in the gross to net reporting in premiums and losses
- Significant fluctuations in premiums written by agents or managing general agents

Considering Fraud Risk Factors

2.88 As indicated in paragraph 2.86 item *c*, the auditor may identify events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes or rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists. AU section 316 (AICPA, *Professional Standards*, vol. 1) provides fraud risk factor examples that have been written to apply to most enterprises. Even though tables 2-1 and 2-2 contain lists of fraud risk factors specific to the insurance industry, remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud[12]

2.89 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements established in paragraphs .19–.34 of AU section 316 (AICPA, *Professional Standards*, vol. 1). The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole.

Accounts, Classes of Transactions, and Assertions

2.90 The following may involve a high degree of management judgment and subjectivity and may present risks of material misstatement due to fraud because they are susceptible to manipulation by management:

a. Investments:

  i. Fair value for nonpublic securities and derivatives;

  ii. Recognition of impairment losses on investments;

  iii. Yields assumed on mortgage-backed and asset-backed securities.

b. Deferred Acquisition Costs:

  i. Deferral of acquisition costs (DAC) and whether there is consistent application and allocation techniques annually;

  ii. Assumptions utilized to develop the DAC deferral;

  iii. Recoverability of deferred acquisition costs;

  iv. Determination of substantial change for internal replacements in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-30.[13]

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[12] Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and assessment of risk and the auditor's procedures in response to those assessed risks.

[13] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-30 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts.

c. Reinsurance:

   i. Evaluation of risk transfer, as it is reasonably possible that the reinsurer will realize a significant loss in order to record the reinsurance transaction as reinsurance versus deposit accounting;

   ii. Accrual of adjustable features on reinsurance contracts;

   iii. Reinsurance transactions near year-end with little evidence to support agreement among the parties prior to the effective date;

   iv. Estimates due to time lags in the receipt of reports from cendants.

d. Reserves:

   i. Reasonableness of assumptions used to calculate reserves including payment patterns and development factors on both a paid and incurred basis;

   ii. Manipulation of discount factors used in certain lines of business (workers' compensation and group disability);

   iii. Misclassification of claim costs by line of business;

   iv. Over reserving in one line of business to cover a deficiency in another line of business;

   v. Accruing or releasing reserves related to prior underwriting years;

   vi. Assumptions used in determining the effects of reinsurance on the net reserves;

   vii. Changes in assumptions used to calculate reserves and premium deficiencies by line of business;

   viii. Consistency of methodologies utilized by management from period to period.

e. Other:

   i. Goodwill and intangibles impairment:

      (1) Reasonableness of assumptions used in evaluating potential impairment of goodwill and intangibles.

   ii. Recoverability of deferred tax assets:

      (1) Analysis of recoverability of deferred tax assets.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

2.91 Paragraph .41 of AU section 316 (AICPA, *Professional Standards*, vol. 1) states that material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

A Consideration of the Risk of Management Override of Controls

2.92 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraph .57) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 (AICPA, *Professional Standards*, vol. 1) should be performed to further address the risk of management override of controls. These procedures include (*a*) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (*b*) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (*c*) evaluating the business rationale for significant unusual transactions.

2.93 In conjunction with the evaluation of risk factors that could result in material misstatements due to fraud, auditors should obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments. The auditor should obtain an understanding of the approval process for both standard and nonstandard journal entries and the types of entries that can be authorized and made by members of management. The auditor should identify and select journal entries and other adjustments for testing based on his or her understanding of the entity's controls over journal entries and other adjustments. The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. The auditor focuses procedures on evaluating inappropriate or unauthorized entries, as well as consolidating adjustments or reclassifications in the financial statements that are not reflected in the general ledger. Inappropriate or unauthorized journal entries and adjustments often have unique identifying characteristics. Such characteristics may include entries made to unrelated, unusual or seldom-used accounts or business segments, entries recorded at the end of the period or as post closing entries, entries made before or during the preparation of the financial statements that do not have account numbers, and entries that contain round numbers or a consistent ending number.

Key Estimates

2.94 Key estimates made by management that could be susceptible to material misstatement due to fraud include reserve calculations for unpaid losses and loss adjustment expenses, including reserves for long-tailed claims such as environmental and asbestos exposures, reinsurance recoverables on unpaid losses, adjustable features on reinsurance agreements, calculation of fair market values for privately-placed investments, deferred taxes and related reserves, the calculation of the deferral percentage used in establishing the DAC asset, investment valuation reserves, the assessment of securities for impairments that are other than temporary, and guarantee fund assessment calculations. See also paragraph 2.89 for a description of accounts, classes of transactions, and assertions that may have an inherent risk because they may involve a high degree of management judgment and subjectivity.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

2.95 Auditors should comply with the requirements established in AU section 316 (AICPA, *Professional Standards*, vol. 1) paragraphs .43–.45 concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. As part of the understanding of internal control sufficient to plan the audit, the auditor of a property and liability insurance entity should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation. These programs and controls may involve

a. specific controls designed to mitigate specific risks of fraud, and may include controls to address specific assets susceptible to misappropriation. Examples of such controls include

   i. use of a lock box for the remittance of premium receipts.

   ii. management quality control review of claim payments.

   iii. established authorization and approval levels for underwriters and claim adjusters.

b. broader programs designed to prevent, deter, and detect fraud. Examples of such controls include

   i. programs to promote a culture of honesty and ethical behavior. Management sets the tone at the top, by establishing a code of conduct and promoting a strong value system.

   ii. evaluating and monitoring appropriate controls and monitoring activities. Because of the importance of information technology in supporting operations and the processing of transactions, management also needs to implement and maintain appropriate controls, whether automated or manual, over computer-generated information.

2.96 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies may exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment[14]

2.97 Paragraphs .46–.67 of AU section 316 (AICPA, *Professional Standards*, vol. 1) provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraph .50).

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[14] Paragraph .03 of AU section 318 states that to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04–.07 of AU section 318. This requirement provides a link between the auditor's consideration of fraud and assessment of risk and the auditor's procedures in response to those assessed risks.

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraphs .51–.56). The property and liability insurance auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures in the following ways:

i. The nature of auditing procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more audit evidence may be needed from independent sources outside the entity, such as confirmations regarding reinsurance transactions or collateral account balances.

ii. The timing of substantive tests may need to be modified. The auditor might conclude that substantive testing be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud. Such accounts that could be tested at year-end may include reserves and market-value testing for investments.

iii. The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level (that is, by product line) may be appropriate for premiums or reserves. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

iv. The auditor may wish to consider the controls in place to prevent unauthorized access and changes to policyholder information or the auditor may find it necessary to confirm certain policy information directly with the policyholder. The auditor may also consider the controls in place related to proper authorization, due diligence, and underwriting of new investments, as well as accounting controls over investment valuation.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraphs .57–.67 and paragraph 2.95).

Evaluating Audit Evidence

2.98 Paragraphs .68–.78 of AU section 316 (AICPA, *Professional Standards*, vol. 1) provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

2.99 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

2.100 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. Paragraphs .75–.78 of AU section 316 (AICPA, *Professional Standards*, vol. 1) provide requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

2.101 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.[15]

b. consider the implications for other aspects of the audit (see AU section 316 [AICPA, *Professional Standards*, vol. 1] paragraph .76).

c. discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.[16]

d. if appropriate, suggest that the client consult with legal counsel.

The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others

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[15] AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on auditors' reports issued in connection with audits of financial statements.

[16] If the auditor believes senior management may be involved, discussion of the matter directly with those charged with governance may be appropriate.

with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

2.102 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs .79–.82 of AU section 316 (AICPA, *Professional Standards*, vol. 1) for further requirements and guidance about communications with management, those charged with governance, and others.

Documentation and Guidance

2.103 Paragraph .83 of AU section 316 (AICPA, *Professional Standards*, vol. 1) provides requirements and guidance regarding certain items and events that the auditor should document. Other sources of guidance include AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1), and AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1). Additionally, the AICPA Practice Aid *Fraud Detection in a GAAS Audit—Revised Edition* provides a wealth of additional information to assist auditors in understanding the requirement and guidance established by AU section 316 (AICPA, *Professional Standards*, vol. 1). This practice aid is an *other auditing publication* as defined in AU section 150. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS.

Auditing Fair Value Measurements and Disclosures[†]

2.104 Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, it addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components

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[†] FASB ASC 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value that applies broadly to financial and nonfinancial assets and liabilities and improves the consistency, comparability, and reliability of the measurements. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. The expanded disclosures about the use of fair value to measure assets and liabilities will provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period.

FASB ASC 825, *Financial Instruments*, addresses the fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. Insurance and reinsurance contracts that meet the definition of a financial instrument are defined within the scope of FASB ASC 825, as are insurance contracts that do not prohibit settlement of the insurer's obligation by payment to a third-party provider of goods or services rather than by payment to the insured or other claimant and certain nonfinancial assets and nonfinancial liabilities.

of equity presented or disclosed at fair value in financial statements. The following areas are discussed:

- Understanding the entity's process for determining fair value measurements and disclosures and the relevant controls, and assessing risk
- Evaluating conformity of fair value measurements and disclosures with U.S. GAAP
- Engaging a specialist
- Testing the entity's fair value measurements and disclosures
- Disclosures about fair values
- Evaluating the results of audit procedures
- Management representations
- Communication with those charged with governance

2.105 Evidence obtained outside the scope of AU section 328 also may provide relevant information in regards to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value may provide relevant evidence about its valuation.

2.106 Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, vol. 1, AU sec. 9328 par. .01–.04), and Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 9332 par. .01–.04), provide additional guidance for auditors when auditing fair value measurements. These interpretations clarify that simply receiving a confirmation from a third party (including a trustee) does not in and of itself constitute adequate audit evidence with respect to the valuation assertion of interests in trusts or investments in securities. The interpretations also reiterate the responsibility of management to institute accounting and financial reporting processes for the determination of fair value measurements. According to the interpretations, if the auditor is unable to audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to qualify his or her opinion or disclaim an opinion.[17]

Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule

2.107 The NAIC's *Annual Statement Instructions Requiring Annual Audited Financial Report*, which incorporates the *January 1991 Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in October 1998)

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[17] The AICPA's nonauthoritative practice aid *Alternative Investments Audit Considerations—A Practice Aid for Auditors* is located at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf and addresses challenges associated with auditing investments for which a readily determinable fair value does not exist. Additionally, the AICPA has issued an auditor's toolkit titled "Auditing Fair Value Measurements and Disclosures: Allocations of the Purchase Price Under FASB Statement of Financial Accounting Standards No. 141, *Business Combinations*, and Tests of Impairment Under FASB Statements No. 142, *Goodwill and Other Intangible Assets*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*."

(herein after called the Model Audit Rule), requires auditors to communicate in a certain form and content with state insurance regulators. Though some states have laws or regulations that differ from the Model Audit Rule, this guide addresses only the requirements of the Model Audit Rule. The NAIC adopted revisions to the Model Regulation in June of 2006 that considered certain provisions of the Sarbanes-Oxley Act of 2002. Highlights of the significant changes to the current Model Audit Rule related to Sarbanes-Oxley include the following:

- *Section 7*. The time allowed to serve in the capacity as the lead or coordinating audit partner was decreased from seven years to five consecutive years with a new five year break in service (previously two years), effective beginning with year 2010 statutory audits.
- *Section 7*. A list of nonaudit services that cannot be performed by the auditor (the prohibitions generally agree with those designated by the SEC), effective for the year 2010 statutory audits.
- *Section 11*. Auditors should prepare a written communication of any unremediated material weaknesses that the insurer will furnish the domiciliary commissioner, effective beginning with year 2010 statutory audits. The current Model Audit Rule requires the auditor to prepare a report of significant deficiencies and material weaknesses in the insurer's internal control structure noted by the auditor during the audit.
- *Section 14*. New specifications for the responsibilities of audit committees and the required qualifications of audit committee members is effective January 1, 2010. The adopted revisions require that insurance entities have an audit committee that is solely responsible for the appointment, compensation, and oversight of the entity's auditor. The guidance also indicates that some audit committees, based on the insurer's premium volume, would need to comprise a certain percentage of individuals who are independent from management.
- *Section 16*. Every insurer required to file an audited financial report that has an annual direct written and assumed premium of $500 million or more shall prepare a report of the insurers' or group of insurers' *internal control over financial reporting* and file it with their insurance commissioner, effective December 31, 2010. The Model Audit Rule also includes a list of what should be included in *management's report on internal control over financial reporting*. This report is prepared by management and is not audited.
- *Section 17*. An insurer may make written application to the commissioner for waiver from any or all provisions of the model based upon financial or organizational hardship. For example, the commissioner could, under this section, grant a waiver of the Section 14B audit committee independence requirements to an entity exceeding the $500 million premium threshold, even though the Section 14H waiver would not apply. This exemption is granted at the discretion of the commissioner and may be granted at any time for a specified period or periods.

2.108 *Awareness*. Section 6 of the revised Model Audit Rule requires that the insurer notify the insurance commissioner of the state of domicile of the name and address of the insurer's independent CPA, hereinafter referred to as *auditor*. In connection with that notification, the insurer is required to obtain an awareness letter from its auditor stating that the auditor

a. is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and financial matters.

b. will issue a report on the financial statements in the terms of their conformity to the SAP prescribed or otherwise permitted by the insurance department of the state of domicile, specifying exceptions as appropriate. See exhibit 2-1, "Illustration of the Accountant's Awareness Letter."

In addition, certain states require additional assertions. For most states, the awareness letter is only required to be filed once, in the first year engaged to perform the audit (within 60 days of becoming subject to the rules). The filing deadline for most states is December 31 of the year being audited. A few states require a letter to be filed annually. Some states have more specific requirements regarding contracts, licensure, and rules of domicile. Practitioners can check individual state regulations for the complete requirements of that state.

2.109 *Change in auditor*. Section 6 of the revised Model Audit Rule requires that insurers notify the insurance department of the state of domicile within 5 business days of the dismissal or resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within 10 business days of that notification, the insurer also is required to provide a separate letter stating whether, in the 24 months preceding the event, there were any disagreements, subsequently resolved or not, with the former auditor on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of the former auditor, would have caused the auditor to make reference to the subject matter of the disagreement in connection with the auditor's opinion. The revised Model Audit Rule requires that the insurer provide the insurance department of the state of domicile a letter from the former auditor to the insurer indicating whether the auditor agrees with the statements in the insurer's letter and, if not, stating the reasons for the disagreement. The disagreements required to be reported in response to this section include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Disagreements contemplated by this section are those that occur at the decision-making level; that is, between personnel of the insurer responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report. The insurer should also in writing request the former accountant to furnish a letter addressed to the insurer stating whether the accountant agrees with the statements contained in the insurer's letter and, if not, stating the reasons for which he or she does not agree; and the insurer should furnish the responsive letter from the former accountant to the commissioner together with its own. See exhibit 2-2, "Illustration of the Change in Auditor Letter."

2.110 *Qualifications*. Section 12 of the revised Model Audit Rule requires the auditor to provide a letter to the insurer to be included in the annual financial report stating

a. the auditor is independent with respect to the insurer and conforms with the standards of his or her profession as contained in the Code of Professional Conduct and pronouncements of the AICPA and the Rules of Professional Conduct of the appropriate state board of public accountancy.

b. the background and experience in general of the individuals used for an engagement and whether each is a CPA. Nothing within this regulation shall be construed as prohibiting the auditor from utilizing such staff as he or she deems appropriate where use is consistent with the standards prescribed by generally accepted auditing standards.

c. the auditor understands that the annual audited statutory financial statements and his or her opinion thereon will be filed in compliance with the requirements of the revised Model Audit Rule and that the domiciliary commissioner will be relying on the information in the monitoring and regulating of the financial position of insurers.

d. the auditor consents to the working paper requirement contained in the revised Model Audit Rule and agrees to make the working papers and other audit documentation available for review by the domiciliary commissioner or the commissioner's designee under the auditor's control, the *working papers*, as defined in Section 13 of the revised Model Audit Rule.

e. a representation that the auditor is properly licensed by an appropriate state licensing authority and is a member in good standing in the AICPA.

f. the auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the revised Model Audit Rule. (Section 7 of the NAIC revised Model Audit Rule has been revised effective for the year 2010 statutory audits, The list of nonaudit services that cannot be performed by the auditor has been revised to generally agree with those designated by the SEC. Readers can also refer to the *Implementation Guide for the Annual Financial Reporting Model Regulation*, located in appendix G of the NAIC *Accounting Practices and Procedure Manual*.)[‡]

See exhibit 2-3 for an "Illustrative Accountant's Letter of Qualification."

2.111 *Notification of adverse financial condition.* Section 10 of the revised Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within 5 business days of determination of 1 of the following:

a. The insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under audit

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[‡] The NAIC adopted revisions to the Model Regulation in June of 2006 that considered certain provisions of the Sarbanes-Oxley Act of 2002. Section 7 of the NAIC revised Model Audit Rule, "Qualifications of Independent Certified Public Account," has been revised effective for the year 2010 statutory audits, The list of nonaudit services that cannot be performed by the auditor has been revised to generally agree with those designated by the SEC. Readers can also refer to the *Implementation Guide for the Annual Financial Reporting Model Regulation*, located in appendix G of the NAIC *Accounting Practices and Procedure Manual*.

The guide has been published prior to the 2010 effective date in order to assist companies in planning and preparing for compliance with the new requirements when they become effective.

b. The insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date

The revised Model Audit Rule also requires the insurer to provide both of the following:

a. To the insurance commissioner of the state of domicile, a copy of the notification of adverse financial condition within five days of its receipt

b. To the auditor, evidence that the notification has been provided to the insurance commissioner

If the auditor receives no such evidence, the revised Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next 5 business days. (Certain states require direct notification to the insurance commissioner from the auditor as a matter of course). See exhibit 2-4, "Illustration of Notification of Financial Condition Letter When the Audit Is Complete," which indicates adverse financial conditions.

2.112 *Report on internal controls.*[||] Effective for year-end 2010 statutory audits, Section 11 of the revised Model Audit Rule requires that insurers provide the commissioner with a written communication as to any unremediated material weaknesses in its internal control over financial reporting noted during the audit. Such communication should be prepared by the auditor within 60 days after the filing of the annual audited financial report, and should contain a description of any unremediated material weakness (as the term *material weakness* is defined by Statement on Auditing Standard 60, *Communication of Internal Control Related Matters Noted in an Audit*, or its replacement) as of December 31 immediately preceding (so as to coincide with the audited financial report discussed in Section 4(A) of the revised Model Audit Rule) in the insurer's internal control over financial reporting noted by the auditor during the course of their audit of the financial statements. If no unremediated material weaknesses were noted, the communication should so state. The insurer is also required to provide a description of remedial actions taken or proposed to correct unremediated material weaknesses, if the actions are not described in the accountant's communication. The insurer is expected to maintain information about significant deficiencies communicated by the independent CPA. Such information should be made available to the examiner conducting a financial condition examination for review and kept in such a manner as to remain confidential.

2.113 PCAOB Auditing Standard No. 5 and AU section 325 define a *significant deficiency* as deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the entity's financial reporting. PCAOB Auditing Standard No. 5 and AU section 325 define a *material weakness* as a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected

[||] For assistance with the year 2009 statutory reporting, the revised 2007 publication *A Statutory Framework for Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators* outlines a suggested framework for auditors to follow when reporting internal control deficiencies related to financial reporting identified during the course of an annual audit of statutory financial statements in accordance with AU section 325. The framework should be read in conjunction with Section 11 of the Model Audit Rule and AU section 325.

and corrected on a timely basis. For purposes other than satisfying Section 11 of the revised Model Audit Rule, the auditor also has to consider any additional reporting requirements of AU section 325 and AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), or AU section 380, *Communication With Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

SEC Requirements for Management's Report on Internal Control Over Financial Reporting

2.114 As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted final rules requiring entities subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment entities, to include in their annual reports a report of management on the entity's internal control over financial reporting. See the SEC website at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation. In its Final Rule Release No. 33-8238, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, the SEC directs entities subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment entities, to include in their annual reports a report of management on the entity's internal control over financial reporting. Issued for the purpose of implementing Section 404 of the Sarbanes-Oxley Act of 2002, this rule is effective August 14, 2003, and requires registrants to (*a*) take responsibility for establishing and maintaining adequate internal control structure and procedures for financial reporting and (*b*) assess their effectiveness at the end of each fiscal year. Moreover, the final rule requires an entity's annual report to include an internal control report of management that contains

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the entity.
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control.
- management's assessment of the effectiveness of internal control over financial reporting as of the end of the entity's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective.
- disclosure of any material weaknesses in internal control over financial reporting. Management is not permitted to conclude that the entity's internal control over financial reporting is effective if there are one or more material weaknesses.
- a statement that its auditor has issued an attestation report on management's assessment of internal control over financial reporting. The auditor's attestation report must be included in the entity's annual report.[18]

[18] SEC Final Rule Release No. 33-8238, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, has been amended multiple times by subsequent final rules, primarily for purposes of extending the compliance dates and providing transition guidance for newly public entities.

(continued)

With respect to the application of this rule to quarterly reporting required under the Securities Exchange Act of 1934, management's responsibilities are less extensive than those required for annual reporting. Management must, with the participation of the principal executive and financial officers, evaluate any change in the entity's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

2.115 The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. Management does not consider other aspects of control, such as controls pertaining to operating efficiency. The SEC's definition of internal control encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

2.116 For quarterly reporting, the SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting. Additionally, management is required to evaluate the effectiveness of the entity's disclosure controls and procedures and issue a report as to their effectiveness on a quarterly basis. With these rules, the SEC introduced a new term, *disclosure controls and procedures*, which is different from internal controls over financial reporting and much broader.

2.117 As defined, *disclosure controls and procedures* encompass the controls over all material financial and nonfinancial information in Securities Exchange Act of 1934 reports. Information that would fall under this definition that would not be part of an entity's internal control over financial reporting might include the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings. See paragraphs 1.51–.56 and the preface section of this guide for additional information.

2.118 Effective for year-end 2010 statutory audits, according to Section 16 of the revised Model Audit Rule, every insurer that is required to file an audited financial report (that has annual direct written and assumed premiums of $500,000,000 or more) is required to prepare a report of the insurer's or group of insurers' internal control over financial reporting. The report should be filed with the commissioner along with the communication of internal control related matters noted in an audit described under Section 11 of the revised Model Audit Rule (as discussed in paragraph 5.112). Management's report of internal control over financial reporting shall be as of December 31 immediately preceding.

(footnote continued)

Currently, with regards to compliance dates associated with Section 404 of the Sarbanes-Oxley Act of 2002 that are not yet effective on June 1, 2009, SEC Final Rule Release No. 33-8934, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, provides that a nonaccelerated filer will be required to file the auditor's attestation report on internal control over financial reporting when it files an annual report for a fiscal year ending on or after December 15, 2009.

PCAOB Auditing Standard No. 5 clarifies that the auditor's report must include the auditor's opinion on whether the entity maintained effective internal control over financial reporting. The standard eliminates the requirement that the auditor also include an opinion on whether management's assessment of the effectiveness of the entity's internal control over financial reporting is fairly stated.

An insurer or a group of insurers that is (*a*) directly subject to Section 404; (*b*) part of a holding company system whose parent is directly subject to Section 404; (*c*) not directly subject to Section 404 but is a Sarbanes-Oxley Act of 2002 compliant entity; or (*d*) a member of a holding company system whose parent is not directly subject to Section 404 but is a Sarbanes-Oxley Act of 2002 compliant entity may file its or its parent's Section 404 report and an addendum in satisfaction of this Section 16 requirement provided that those internal controls of the insurer or group of insurers having a material impact on the preparation of the insurer's or group of insurers' audited statutory financial statements (those items included in Section 5B through 5G of this regulation) were included in the scope of the Section 404 report.

2.119 Management's report of internal control over financial reporting as required under Section 16 of the revised Model Audit Rule should include the following:

a. A statement that management is responsible for establishing and maintaining adequate internal control over financial reporting.

b. A statement that management has established internal control over financial reporting and an assertion, to the best of management's knowledge and belief, after diligent inquiry, as to whether its internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles.

c. A statement that briefly describes the approach or processes by which management evaluated the effectiveness of its internal control over financial reporting.

d. A statement that briefly describes the scope of work that is included and whether any internal controls were excluded.

e. Disclosure of any unremediated material weaknesses in the internal control over financial reporting identified by management as of December 31 immediately preceding. Management is not permitted to conclude that the internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles if there is one or more unremediated material weaknesses in its Internal control over financial reporting.

f. A statement regarding the inherent limitations of internal control systems.

g. Signatures of the chief executive officer and the chief financial officer (or equivalent position or title).

Management should document and make available upon financial condition examination the basis upon which its assertions are made. Management may base its assertions, in part, upon its review, monitoring, and testing of internal controls undertaken in the normal course of its activities. Management has discretion as to the nature of the internal control framework used, and the nature and extent of documentation, in order to make its assertion in a cost effective manner and, as such, may include assembly of or reference to existing documentation.

Auditor's Consideration of State Regulatory Examinations

2.120 AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), states that the auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1) states "The auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor." Accordingly, it is appropriate that the auditor may review examination reports and related communications between regulators and the insurance enterprises to obtain sufficient appropriate audit evidence. Regulators are assessing changes to the current examination process with consideration being given to a risk-focused approach. The objective is to provide a more efficient process to monitor and assess an insurer's solvency. The process would include a risk-focused financial analysis along with a review of internal and external changes affecting the insurer. A proposed output of the process is a rating system that would assist regulators in developing the supervisory plan for the insurer.

2.121 The auditor may review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor may

- request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

2.122 Paragraphs .22–.34 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), establish requirements and guidance regarding scope limitations and auditors' reports issued in connection with audits of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with U.S. GAAP. If management refuses to allow the auditor to communicate with the regulator or review communications with the regulator or if the regulator refuses to communicate with the auditor, then the auditor may qualify his or her opinion due to a limitation on the scope of the audit depending on the auditor's assessment of other relevant facts and circumstances.

Auditor's Consideration of Permitted Statutory Accounting Practices

2.123 Prescribed statutory accounting practices are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises may review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

2.124 Permitted statutory accounting practices include practices not prescribed by the domiciliary state, as described in paragraph 2.119, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from entity to entity within a state, and may change in the future.

2.125 Auditors should exercise reasonable care and diligence in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters. For each examination, auditors should obtain sufficient appropriate audit evidence to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the domiciliary state regulatory authority.

2.126 Although exceptions may exist, the following generalizations about the reliability of audit evidence are useful:

- Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity
- Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control)
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed)
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

2.127 If the auditor is unable to obtain sufficient appropriate audit evidence to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor may qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit.

The Auditor's Consideration of Regulatory RBC for Property and Liability Insurance Enterprises

Introduction and Scope

2.128 Property and liability insurance enterprises operate in a highly regulated environment. The regulation of property and liability insurance enterprises is directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the property and liability insurance system. One of the primary tools used by state insurance departments for ensuring that those objectives are being achieved is RBC.

2.129 This section of the guide addresses the auditors' responsibility that arises from the RBC requirements imposed on property and liability insurance enterprises. These RBC requirements affect audits of property and liability insurance enterprises in the following three primary areas:

a. Audit planning

b. Going-concern considerations

c. Other reporting considerations

Overview of RBC[19]

2.130 Regulation of property and liability insurance enterprises has historically focused on their capital. The NAIC requires property and liability insurance enterprises to disclose RBC in their statutory filings. The RBC calculation serves as a benchmark for the regulation of property and liability insurance enterprises' solvency by state insurance regulators. RBC requirements set forth dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Such formulas focus on four general types of risk:

a. The risk related to the insurer's assets (asset risk)[20]

b. The credit risk related to the collectability of insurance recoverables and miscellaneous receivables (credit risk)

c. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations including excessive premium growth (underwriting risk)

d. All other business risks (management, regulatory action, and contingencies)

The amount determined under such formulas is called the authorized control level (ACL) RBC.

2.131 RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a property and liability insurance enterprise's total adjusted capital (TAC) (equal to the sum of statutory capital and surplus and such other items, if any, as the NAIC's RBC

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[19] The NAIC Task Force is reviewing risk based capital levels. Readers should be alert to any new developments.

[20] This risk also includes risk of default.

instructions[21] may provide) to the calculated ACL. The levels of regulatory action, the trigger point, and the corrective actions are summarized as follows:

RBC Levels and Corrective Actions

Level	*Trigger*	*Corrective Action*
Company Action Level RBC (CAL)	Total adjusted capital (TAC) is less than or equal to 2 x ACL, or TAC is less than or equal to 2.5 x ACL with negative trend	The property and liability insurance enterprise must submit a comprehensive plan to the insurance commissioner.
Regulatory Action Level RBC (RAL)	TAC is less than or equal to 1.5 x ACL, or unsatisfactory RBC Plan	In addition to the action mentioned, the insurance commissioner is required to perform an examination or analysis deemed necessary and issue a *corrective order* specifying corrective actions required.
Authorized Control Level RBC (ACL)	TAC is less than or equal to 1 x ACL	In addition to the actions described, the insurance commissioner is permitted but not required to place the property and liability insurance enterprise under regulatory control.
Mandatory Control Level RBC (MCL)	TAC is less than or equal to .7 x ACL	The insurance commissioner is required to place the property and liability insurance enterprise under regulatory control.

2.132 Under the RBC requirements, the comprehensive financial plan should

a. identify the conditions in the insurer that contribute to the failure to meet the capital requirements.

b. contain proposals of corrective actions that the insurer intends to take and that would be expected to result in compliance with capital requirements.

c. provide projections of the insurer's financial results in the current year and at least the four succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions.

[21] The NAIC's risk-based capital (RBC) instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

d. identify the key assumptions impacting the insurer's projections and the sensitivity of the projections to the assumptions.

e. identify the quality of, and problems associated with the insurer's business, including but not limited to its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and use of reinsurance in each case, if any.

Audit Planning

2.133 The objective of an audit of a property and liability insurance enterprise's financial statements is to express an opinion on whether they present fairly, in all material respects, the enterprise's financial position, results of operations, and cash flows in conformity with U.S. GAAP. To accomplish that objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs further audit procedures that are responsive to the assessed risks to provide reasonable assurance that the financial statements are free of material misstatements. Because of the importance of RBC to property and liability insurance enterprises, RBC may be considered in assessing the risks of material misstatement and planning the audit. The auditor may obtain and review the client's RBC reports to further his or her understanding of the RBC requirements for preparing such reports and the actual regulations associated with RBC.

Going-Concern Considerations[#]

2.134 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), establishes requirements and guidance on the auditor's responsibility to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of a property and liability insurance enterprise's ability to continue as a going concern is whether the enterprise complies with regulatory RBC requirements.[22]

2.135 In view of the serious ramifications of noncompliance with regulatory RBC requirements for property and liability insurance enterprises (see paragraph 2.126), such failure is a condition that indicates that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Accordingly, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of the noncompliance with regulatory RBC capital requirements or events that

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[#] In October 2008, FASB issued an exposure draft proposed statement, *Going Concern*, that would provide guidance on the preparation of financial statements as a going concern and on management's responsibility to evaluate a reporting entity's ability to continue as a going concern. It also would require certain disclosures when either financial statements are not prepared on a going concern basis or when there is substantial doubt as to an entity's ability to continue as a going concern. Currently, FASB is reviewing new developments related to newly drafted language that is aimed to clarify the disclosure requirements related to management's going-concern assessment, including the development of language to replace the term *substantial doubt*, and will decide whether it will issue a revised exposure draft by the end of the second quarter of 2010.

[22] Auditors should evaluate a property and liability insurance enterprise's ability to continue as a going concern even if the enterprise meets the minimum RBC standards. There are other conditions and events that may indicate that there could be substantial doubt about a property and liability insurance enterprise's ability to continue as a going concern, such as recurring operating losses, indications of strained liquidity, concerns expressed by regulators, and indications of strained relationships with regulators.

gave rise to the condition and assess the likelihood that such plans can be implemented. In evaluating management's plans, the auditor may consider

a. the property and liability insurance enterprise's existing regulatory capital position.

b. whether a comprehensive financial plan has been filed and, if so, whether it has been accepted by the regulators.

2.136 The auditor may consider the amount of any RBC capital deficiency. In general, the lower the ratio of TAC to ACL RBC, the greater the doubt about the enterprise's ability to continue as a going concern for a reasonable period. The auditor may also assess the likelihood that the property and liability insurance enterprise's regulatory capital position will improve or deteriorate in the next 12 months.

2.137 The auditor may also consider the nature or source (asset quality, underwriting, collectibility, or other) of the deficiency. Curing deficiencies from certain sources may be more within the control of the management of the property and liability insurance enterprise than curing deficiencies from other sources.

2.138 Furthermore, the auditor may ascertain whether a comprehensive financial plan has been filed and accepted by the commissioner. If the commissioner has accepted the comprehensive financial plan, the auditor may identify those elements of the comprehensive financial plan that are particularly significant to overcoming the adverse effects of the failure to comply with regulatory RBC requirements and may identify and perform auditing procedures to obtain sufficient appropriate audit evidence about the significant elements. For example, the auditor may consider the adequacy of support regarding an enterprise's ability to obtain additional capital or a planned disposal of assets. When prospective financial information is particularly significant to management's plans, the auditor may request that management provide the information and may consider the adequacy of support for significant assumptions that underlie it. Further, the auditor may identify those elements of the comprehensive financial plan and conditions placed on the property and liability insurance enterprise by the commissioner that are most difficult to achieve and consider the likelihood that the property and liability insurance enterprise will not be able to implement the elements successfully.

2.139 If the commissioner has rejected the comprehensive financial plan, the auditor may consider the commissioner's reasons for rejecting it, any revisions proposed by the commissioner to render the comprehensive financial plan satisfactory, management's intentions for revising the comprehensive financial plan, and possible regulatory sanctions. If the commissioner has not yet notified the insurer whether the comprehensive financial plan has been accepted,[23] the auditor may review related communication between the commissioner and the property and liability insurance enterprise and make inquiries of both management and regulatory officials to determine the current status of the comprehensive financial plan. If the property and liability insurance enterprise has not filed a financial plan with the commissioner,[24] the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

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[23] The RBC requirements require the commissioner to notify the insurer whether the comprehensive financial plan is accepted or is unsatisfactory within 60 days of submission of the plan.

[24] The RBC requirements require that a comprehensive financial plan be filed with the commissioner within 45 days of the failure to meet RBC standards.

2.140 After the auditor has evaluated management's plans, the auditor concludes whether substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time remains or is alleviated. This is often a complex judgment that is made by auditors with considerable professional experience.

Substantial Doubt Remains

2.141 If the auditor concludes that substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time remains, the auditor should (*a*) consider the possible effects on the financial statements and the adequacy of the related disclosures[25] and (*b*) add an explanatory paragraph to his or her report expressing substantial doubt about the enterprise's ability to continue as a going concern.

2.142 Additionally, paragraph .18 of AU section 341 states that the auditor should document all of the following:

a. The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.

c. The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.

d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.

e. The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusions as to whether to express a qualified or adverse opinion for the resultant departure from U.S. GAAP.

2.143 Additionally, paragraph .11 of AU section 341 states that if the auditor concludes that substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the need for disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt.

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[25] SEC Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, provides requirements and guidance for auditors of publicly held property and liability insurance enterprises and states that "... filings containing accountants' reports that are qualified as a result of questions about the entity's continued existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

Exhibits

2.144 The following are some examples of letters for State Insurance Regulators to Comply With the NAIC revised Model Audit Rule, referenced throughout paragraphs 2.106–.111.

Exhibit 2-1

Illustration of the Accountant's Awareness Letter[1]

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with auditing standards generally accepted in the United States of America of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of [*name of state of domicile*] and the related rules and regulations of the Insurance Department of [*name of state of domicile*] that are applicable to audits of statutory financial statements of insurance entities. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of ABC Insurance Company as to their conformity with accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*].

The letter is intended solely for the information and use of the Insurance Department of [*name of state of domicile*] and other state insurance departments and is not intended to be and should not be used for anyone other than these specified parties.

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[1] See chapter 8, "Reports on Audited Financial Statements," for sample PCAOB language.

Exhibit 2-2

Illustration of the Change in Auditor Letter

To the Board of Directors of DEF Insurance Company:

We previously were auditors for DEF Insurance Company and, under the date of [*report date*], we reported on the statutory financial statements of DEF Insurance Company as of and for the years ended December 31, 20X1 and 20X0.[1] Effective [*date of termination*], we are no longer auditors of DEF Insurance Company. We have read DEF Insurance Company's statements in its letter dated [*date of insurer's letter*], which is attached hereto, and we agree with the statements therein. [*However, if the auditor is (a) not in a position to agree or disagree or (b) does not agree with the insurer's statement, the auditor's letter should state that the auditor is not in a position to agree or disagree or that the auditor does not agree with such statements and give the reasons*.][2]

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[1] If the auditor had not reported on any financial statements, the first sentence should be modified as follows:

We previously were engaged to audit the statutory financial statements of DEF Insurance Company as of and for the year ending December 31, 20X1.

[2] The insurer's letter may contain a statement, such as

In connection with the audits of the statutory financial statements of the Company for the years ended December 31, 20X2 and 20X1, and the subsequent interim period through [*date of termination*], there were no disagreements with [*CPA Firm*] on any matter of accounting principles, statutory accounting practices (SAP) prescribed or permitted by the Insurance Department of [*name of state of domicile*], financial statement disclosure, or auditing scope or procedures, which disagreements if not resolved to their satisfaction would have caused them to make reference to the subject matter of the disagreement in their reports.

Exhibit 2-3

Illustrative Accountant's Letter of Qualifications[1]

To the Board of Directors of GHI Insurance Company:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the statutory financial statements of GHI Insurance Company (the Company) for the years ended December 31, 20X1 and 20X0, and have issued our report thereon dated [*date of report*]. In connection therewith, we advise you as follows:

a. We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the [*state*] Board of Public Accountancy.

b. The engagement partner and engagement manager, who are certified public accountants, have [*number*] years and [*number*] years, respectively, of experience in public accounting and are experienced in auditing insurance entities. Members of the engagement team, most (some) of whom have had experience in auditing insurance entities and [*number*] percent of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.

c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of [*name of state of domicile*] and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, the Company and the insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted auditing standards is to form an opinion and issue a report on whether the statutory financial statements present fairly in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*]. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatement resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control that will, among other things, provide reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*].

The Insurance Commissioner should exercise due diligence to obtain whatever other information may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

d. We will retain the working papers[2] prepared in the conduct of our audit until the Insurance Department of [*name of state of domicile*] has filed a Report of Examination covering 20X1, but no longer than seven years. After notification to the Company, we will make the working papers available for review by the Insurance Department of [*name of state of domicile*] at the offices of the insurer, at our offices, at the Insurance Department or at any other reasonable place designated by the Insurance Commissioner. Furthermore, in the conduct of the aforementioned periodic review by the Insurance Department of [*name of state of domicile*], photocopies of pertinent audit working papers may be made (under the control of the accountant) and such copies may be retained by the Insurance Department of [*name of state of domicile*].[3]

e. The engagement partner has served in that capacity with respect to the Company because [*year that current term started*], is licensed by the [*state name*] Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.

f. To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

The letter is intended solely for the information and use of the Insurance Department of [*name of state of domicile*] and other state insurance departments and is not intended to be and should not be used for anyone other than these specified parties.

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[1] See chapter 8, "Reports on Audited Financial Statements," for sample PCAOB language.

[2] Section 13 of the revised Model Audit Rule defines working papers as follows:

Working papers are the records kept by the independent certified public accountant of the procedures followed, the test performed, the information obtained, and the conclusions reached pertinent to the accountant's examination of the financial statements of an insurer. Working papers, accordingly, may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of entity documents and schedules or commentaries prepared or obtained by the independent certified public accountant in the course of his or her examination of the financial statements of an insurer and which support the accountant's opinion.

[3] Auditing Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator" of AU section 339 (AICPA, *Professional Standards*, vol. 1, AU sec. 9339 par. .01–.15), establishes requirements and provides guidance for auditors regarding the release of confidential client information to a regulator.

Exhibit 2-4

Illustration of Notification of Financial Condition Letter When the Audit Is Complete[1,2]

To the Board of Directors:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the statutory financial statement of MNO Insurance Company (the Company) as of December 31, 20X1 and 20X0, and have issued our report thereon dated [*date of report*].

In connection with our audit, we determined that capital and surplus reflected in the statement of admitted assets, liabilities, and capital and surplus of the Company as of December 31, 20X1, as reported on the 20X1 Annual Statement filed with the Insurance Department of [*name of state*] is materially misstated because [*provide explanation*]. Statutory capital and surplus of $__reported on the 20X1 Annual Statement should be reduced by $__as a result of the matter in the preceding sentence.[3]

If we do not receive evidence that the Company has forwarded a copy of this letter to the insurance commissioner of [*name of state*] within five business days of receipt, we are required to give the insurance commissioner a copy of this letter within the next five business days.

The letter is intended solely for the information and use of the Insurance Department of [*name of state of domicile*] and other state insurance departments and is not intended to be and should not be used for anyone other than these specified parties.

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[1] A determination that financial statements filed with a state insurance department contain a material misstatement does not necessarily always occur when an audit is complete. The Model Audit Rule requires notification to be provided within five business days of such determination. The language in this illustration letter should be modified depending on the relevant facts and circumstances.

[2] See chapter 8, "Reports on Audited Financial Statements," for sample PCAOB language.

[3] The wording of this paragraph is intended for those situations in which audit adjustments would not cause minimum capital and surplus of an insurer to fall below statutory requirements. The paragraph should be reworded if the entity did not meet minimum capital and surplus requirements as presented on its Annual Statement as filed with the domiciliary commissioner.

Chapter 3

The Premium Cycle

3.01 Insurance entities record premiums in premiums written accounts. As policy periods expire, the premiums written are earned and are recognized as revenue. The pro rata portion of premiums written allocable to unexpired policy periods represents unearned premiums, which are reflected as a liability in the balance sheet. Premiums written are also used as a basis for paying commissions to agents, calculating premium taxes, and guaranty fund assessments.[1] The following are definitions of several kinds of written premiums:

direct premiums. Premium income less return premiums arising from policies issued by the entity collecting the premiums and acting as the primary insurance carrier.

assumed reinsurance premiums. Premium income less return premiums arising from policies issued or other contracts entered into to reinsure other insurance entities that provide the related primary coverage.

ceded reinsurance premiums. Outgoing premiums less return premiums arising from reinsurance purchased from other insurance entities.

return premiums. Premium refunds due to insureds, arising from endorsements (changes in coverage, term, and so on), cancellations, or audits.

3.02 Under statutory accounting practices (SAP), Statement of Statutory Accounting Principle (SSAP) No. 53, *Property Casualty Contracts—Premiums*, paragraph 3 notes "written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract." This definition is for all property casualty contracts other than workers compensation. For workers compensation contracts, the premium may vary periodically based upon changes in the activities of the insured, and written premiums may be recorded on an installment basis to match the billing to the policyholder.

Rating

3.03 Rates used by an insurance entity are based on the entity's experience by line of insurance or the industry loss experience compiled by advisory rating organizations, which are subject to supervision and regulation by state insurance departments. The principal rating organizations are the National Council on Compensation Insurance for workers' compensation insurance, the Surety and Fidelity Association of America for fidelity and surety insurance, and the Insurance Services Office for all other property and liability lines of insurance.

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[1] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 405-30 provides guidance on accounting by insurance and other enterprises for guaranty-fund and other assessments. For statutory accounting practices (SAP), see Statement of Statutory Accounting Principle No. 35, *Guaranty Fund and Other Assessments*, for guidance. SAP has rejected FASB ASC 405-30; see paragraph 3.34 for discussion.

3.04 States have established mechanisms to provide insurance to those with high risks who would otherwise be excluded from obtaining coverage. For property in high-risk areas, Fair Access to Insurance Requirements (FAIR) plans, which are federally approved and state supervised, provide insurance to owners. Entities that operate in a state are assessed for any underwriting loss experienced by the FAIR plan in the state.

3.05 As discussed in chapter 1, "Nature, Conduct, and Regulation of the Business," states have several methods of apportioning involuntary automobile insurance. These methods include automobile insurance plans, joint underwriting associations, and reinsurance pools or associations.

The Transaction Cycle

3.06 The premium cycle normally includes the following functions, which generate most premium-related transactions:

- Evaluating and accepting risks
- Issuing policies
- Billing and collecting premiums
- Paying commissions and other costs of acquiring business
- Adjusting premiums
- Home office and branch office recordkeeping

Evaluating and Accepting Risks

3.07 The evaluation and risk-accepting function has three general objectives: to evaluate the acceptability of the risk, to determine the premium, and to evaluate the entity's capacity to retain the entire risk.

3.08 To initiate new business, an agent or broker submits to the entity an application for a policy, often with a deposit from the customer for a portion of the estimated premium. Pending issuance of the policy, the agent or broker provides the insured with a binder, which is a temporary contract that may be oral or written. The period covered by the binder is usually short, often limited to 30 days or less. A written binder is evidence of an understanding by both parties of what the insurance covers, the amount of insurance, the premium charged, and the entity writing the insurance. The cash is recorded in a clearing (suspense) account and deposited, and the application is forwarded to the entity's underwriting department for evaluation. The risks are evaluated in accordance with entity procedures; these may include a review of exposure and potential loss based on the applications, changes, or endorsements to existing policies submitted by the agent or broker. For example, applications for automobile insurance may be checked by requesting motor vehicle reports issued by a state department of motor vehicles. For certain types of property coverage, engineering surveys or fire hazard surveys may be necessary.

3.09 If an application is denied, the deposit premium is returned to the applicant with an explanation. When the refund is sent, the suspense account is cleared.

3.10 If the underwriter determines that the applicant falls within the entity's underwriting guidelines and is an acceptable risk, an underwriting report is prepared, and the risk is coded so that the entity can prepare reports concerning premiums, such as

- premiums by state, by line of business, and by underwriting year, which are required to be included in the entity's annual statement.
- premiums written by territory and by class of risk, required by the entity or rating bureaus to aid in rate making.
- premiums by producer, required to prepare agents' production reports and to compute any contingent commissions due at the end of a year.

Proper coding of premiums is important for the reports because it affects areas such as loss ratios by line of business, future underwriting and pricing, treaty reinsurance, premium tax assessments, and contingent commission arrangements.

3.11 Accounting entries are made for accepted applications by crediting premiums written, clearing the premium cash-suspense account for the deposits, and recording the balances due as premiums receivable. The combination of the rating codes entered on the underwriting report becomes the basis for the premium rates charged. A portion of the premiums is deferred because the billed premiums are for coverage to be provided by the insurance entity over the term of the policy. At the end of each reporting period, unearned premiums are calculated, and the change in unearned premiums is recorded as a charge or credit to premium income.

3.12 Premiums are generally established by one of three methods: class or manual rating, individual or judgment rating, or merit rating, which are defined as follows:

- *Class or manual rating* is used primarily to establish rates for various coverages for individuals, families, and small businesses. Based on statistical data, these large groups of similar risks can be classified by a few important and easily identifiable characteristics. These classifications result in standard rates.
- *Individual or judgment rating* is used when the rates for large or unusual risks are established almost entirely by the skill and experience of the rate maker, such as ocean marine risks.
- *Merit rating* is generally used for larger risks of commercial lines and is divided into three types. *Schedule rating* starts with an assumed standard, frequently the manual rate, and adjusts such standard rates according to an evaluation of greater or lesser exposure to risk. Schedule rating is often used in fire insurance or commercial properties. *Experience rating* departs from manual rates based on the insureds' past experiences under the coverage. Premiums are adjusted prospectively based on average past experience. Experience rating is widely used in workers' compensation insurance. *Retrospective experience rating* differs from experience rating in that it adjusts the premium during the period of coverage based on actual experience during that same period. Policies that are retrospectively rated often specify minimum and maximum premiums and, in effect, may leave some risks uninsured. (Paragraph 3.23 discusses retrospective premium adjustments.)

3.13 A renewal of a policy is a new contract but, unless otherwise stated, the terms are those of the original policy. The risk insured under the original policy expires when the policy expires, and each renewal is considered as an application for a new risk. When a policy is renewed, the premium is determined in the same manner as for a new business.

3.14 Finally, after a risk has been accepted and the premium has been calculated, a determination generally should be made as to whether the entire risk should be retained or whether all or part of it should be reinsured. Reinsurance is discussed in detail in chapter 6, "Reinsurance."

Issuing Policies

3.15 Applications and endorsements that have been accepted are submitted, along with an underwriting report, to a coding unit for verification of items on the underwriting report. Verified applications are then coded for data entry into the statistical system. Coded applications are batched, and input control totals are established before delivery to data entry. Alternatively, many entities have the capability to submit applications online. After coded applications and endorsements have been entered into the system, batch control totals generated by the computer are compared to the input control totals. Processing the information generates a premium register and documents known as *declaration sets*, which include the billing statement and insurance ID card, as well as information such as terms of the policy, lines of coverage, premiums, and agent information. The policy, including any endorsements, is prepared, assigned a sequential policy number, and sent directly to the insured or to the agent or broker for distribution.

Billing and Collecting Premiums

3.16 The two basic methods for billing premiums are agency billing and direct billing. Some entities use only one of these methods; others use both. Under direct billing, the entity bills insureds directly for premiums due and, on collection, remits commissions to the agents. The following are several variations of agency billing, also called *account current*:

- *Account current "item basis."* For individual policies, the agent collects the premiums directly from the insureds, subtracts his or her commissions, and remits the net premiums due the entity. If the agent cannot collect a premium during the credit period allowed by the entity, he or she may request cancellation of the policy.
- *Account current "rendering basis."* The agent submits to the insurance entity a statement of all the policies issued or due during the current month, and the net amount of the statement is subsequently to be paid in accordance with the agency agreement. The statement, which includes all known current activity, such as endorsements, cancellations, or audits, is compared to the entity's accounts receivable and adjusted as necessary.
- *Account current "billing basis."* The entity sends the agent a statement that contains a listing of all the policies written or due, minus the policies canceled during the month. The net amount of the statement is to be paid in accordance with the agency agreements.

3.17 The credit terms to agents are usually outlined in the agency agreement. The agent's account current is usually payable within a specified period after the last day of the month of the account.

3.18 Uncollected premiums from an agent represent premiums due the entity from the agent based on his or her contract with the entity to write insurance, to collect the necessary premiums, and to remit the collected premiums net of commissions. Uncollected premiums from an agent are generally reflected as *agents' balances* or *uncollected premiums*, which are netted against the commissions payable on the uncollected premiums. Entities should also consider Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210-20 that defines *right of setoff* and specifies what conditions must be met to have that right.

3.19 Uncollected premiums from policyholders represent premiums due the entity that may have been directly solicited from policyholders either by an agent or by the entity. The entity sends bills directly to the policyholders, and the policyholders remit the premiums directly to the entity. Customers typically have the option of remitting premiums on an installment basis. Policies and billing, therefore, may be on a monthly, quarterly, or annual cycle. If an agent had solicited the business, the entity, after receiving payments from the policyholders, either sends the agent a check or otherwise credits the agent's account for his or her commission. Under direct billing, the entire amount of uncollected premiums is generally recorded as agents' balances or uncollected premiums, and the commissions on the uncollected premiums are not netted but are recorded as a liability.

3.20 The premium collection department is responsible for accounting for customer remittance advices and the agent's account current. Adequate control over these documents is important to ensure that all payments received are processed. Customer and agent remittances generally should be batched and input control totals established before data entry. These input control totals normally should be compared to output control totals generated in the electronic data processing (EDP) department. As a result of processing, the agency cash-receipts register, difference ledger, and agent's aged trial balance are generated. The related files are then updated.

3.21 The agency cash-receipts register is reconciled with the cash-receipts record. The premium register includes information by line of business, such as current premiums, commissions, year-to-date premiums, current expired, premiums in force, and earned and unearned premiums. The difference ledger results from a comparison of accounts current submitted by the agent with transactions recorded on the entity's records. Old outstanding differences and large discrepancies are reviewed and investigated. Differences may occur because the agent and the entity use different cutoff dates or because of errors or omissions by the agent or the entity. An agent's aged trial balance includes information such as the current month's premiums, net premiums, prior balance, cash received, net balance, installment fees, and balance due. The total premium column equals total written premiums shown on the premium register. In addition, the agent's trial balance is reviewed to determine any uncollectible accounts.

Paying Commissions and Other Costs of Acquiring Business

3.22 Agents, both independent and exclusive, and brokers are compensated for their services by commissions. Some commissions are paid on the basis of a standard percentage of premiums or on an agreed scale, known as level commissions. Retroactive commissions are used in areas such as workers' compensation, in which the final premium may be experience rated and the commissions would therefore require adjustment. Contingent commissions result from agreements with agents and brokers whereby the amounts of commissions are contingent on favorable loss experience of the business placed with the entity. Establishing accounting provisions for contingent commissions is difficult because they are based on estimates of the ultimate loss experience, and in many cases the commission period does not coincide with the entity's fiscal year. FASB ASC 944-605-25-14 and FASB ASC 944-605-30-3 discuss accounting for contingent commission arrangements. Refer to SSAP No. 66, *Retrospectively Rated Contracts*, for additional SAP guidance on accounting for contingent commissions.

Adjusting Premiums

3.23 Adjustments to premiums written and to unearned premiums can result from

- *cancellation*, a complete termination of an existing policy before expiration. Cancellation results in a return premium to the insured.
- *endorsements*, changes in existing policies that may result in additional premiums or return premiums, such as increases or decreases in coverage limits, additions or deletions of property or risks covered, or changes in location or status of insureds.
- *audit premiums*, premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. An audit may result in an additional premium or a return premium. An example of a policy subject to audit premiums is a workers' compensation policy for which the premium is based on the payroll of the employer.
- *retrospective premium adjustments*, modifications of the premiums after expiration of the policies. An adjustment is based on the experience of an individual risk during the term of the policy and is generally subject to maximum and minimum premium limits specified in the policy.
- *policyholder dividends*, dividends paid to policyholders either in cash or as credits against each policyholder's next renewal premium.

Home Office and Branch Office Recordkeeping

3.24 Record-processing functions performed through branch locations vary among property and liability insurance entities. Further, those functions may vary depending on whether the entity is direct billing or agency billing. The use of the EDP has decentralized activities through computer input-output devices for remote locations in branch and field offices. For remote entry and access, the branch office, in effect, functions as an extension of the home office's centralized data processing.

3.25 For branch operations in which processing, accounting, and recordkeeping activities are decentralized, several alternative approaches exist. The more efficient and effective methods minimize duplication and result in compatibility between the branch and home office procedures.

3.26 Entities may follow these procedures for controlling policies and applications for policies at their branch offices:

- Applications are forwarded to the home office daily, with or without control listings.
- Applications are accompanied by control listings that have been balanced to entries made in branch records.
- Applications are retained at the branch offices, and only monthly summary journal entries are transmitted to the home office for entry in the general ledger.
- Policy numbers are assigned at branch offices or the home office, and overall numerical control of policies is maintained at the home office.

3.27 Entities may follow these procedures to control cash receipts at their branch offices:

- Branch offices prepare journal entries and forward them with the cash to the home office for deposits.
- Branch offices deposit cash in their branch accounts and transmit copies of the deposit slips and statements of cash applications to the home office.
- Branch offices deposit locally, and forward only the bank receipts to the home office. Branch offices forward monthly journal entries that summarize the monthly deposits to the home office.

3.28 Home office record-maintenance methods may include

- duplication of branch records.
- maintenance of detailed entries of policies for statistical purposes but only a control account for uncollected premiums.
- use of summary controls received monthly from the branches for both premiums and cash.

Premiums Transaction Flow

3.29 The following summarizes the premiums transaction flow of an insurance entity:

a. An agent or broker submits a binder or application for a policy to the insurance entity, often with a deposit premium.

b. Underwriting evaluates the risk, often using predetermined acceptance criteria and other factors such as a knowledge of the agent or broker.

c. If the risk is accepted, the amount of premium is determined, and the policy is issued. Premiums are generally established by class rating, individual rating, or merit rating. If the application is denied, the deposit premium is returned to the applicant with an explanation.

d. A decision to reinsure part or all of the risk is made. If reinsurance is chosen, the reinsurance entity is notified, and the amount of ceded premium is determined.

e. Premiums are billed either by agency billing using an account current with the agent or by direct billing. Written premiums are recorded as an unearned premium reserve and are recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

f. Commissions and other costs of acquiring business are paid. Certain costs, known as *deferred acquisition costs*, typically are capitalized and amortized over the term of the policy.

g. Premiums may be adjusted over the life of the policy or at the expiration of the policy. Adjustments may result from audits, endorsements, or retrospective rating.

Accounting Principles[*,†]

3.30 Many specialized industry accounting principles for insurance enterprises are specified in FASB ASC 944. (Additional guidance is listed in paragraph 4.01.) The following is a brief discussion of the principles and policies relating to the premium cycle. Refer to FASB ASC 944 for specific guidance. Most property and liability insurance contracts are classified as short-duration contracts, and this guide generally focuses on such contracts.

Revenue Recognition[2]

3.31 Under FASB ASC 944-605-25-1, premiums from short-duration contracts should be recognized as revenue over the contract period in proportion to

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[*] FASB ASC 944, *Financial Services—Insurance*, contains specific guidance on accounting for financial guaranty insurance contracts. This guidance was issued in May 2008 as a result of diversity in practice when dealing with financial guarantee insurance contracts. FASB ASC 944 requires that an insurance enterprise recognize a claim liability for financial guarantee insurance contracts prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. It also includes guidance on the recognition and measurement to be used to account for premium revenue and claim liabilities. FASB ASC also requires expanded disclosures about financial guarantee insurance contracts.

[†] The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards (IFRSs) to entites that issue insurance contracts and is now complete. The issuance of IFRS No. 4, *Insurance Contracts*, along with IFRS No. 4 Basis for Conclusions and IFRS No. 4 Implementation Guidance, brought to a close phase I of the international insurance project. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, FASB issued an invitation to comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper*, Preliminary Views on Insurance Contracts. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project. The boards are planning to release an exposure draft in the third quarter 2010. Readers should remain alert to any final pronouncements and refer to the revised FASB IASB Memorandum of Understanding.

[2] For Securities and Exchange Commission registrants, additional guidance is provided by Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, as amended and

(continued)

the amount of insurance provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums should be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

3.32 An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the entity's balance sheet.

3.33 As discussed in FASB ASC 944-605-25-2, if premiums are subject to adjustment (for example, retrospectively rated or other experience-rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue should be recognized as follows:

a. If the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. The estimated ultimate premium should be revised to reflect current experience.

b. If the ultimate premium cannot be reasonably estimated, the cost recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

3.34 Under SAP, written premiums are generally recorded on the effective date of the contract, with an unearned premium reserve established to reflect the amount of premium for the portion of insurance coverage that has not yet expired. SSAP No. 53 notes "The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of contracts shall be recognized in the statement of income, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 7 [of SSAP No. 53]. Certain statements provide for different methods of recognizing premium in the statement of operations for specific types of contracts." As noted in paragraph 3.02, workers compensation contracts have premiums that may vary periodically, which is why premiums are allowed to be recorded on an installment basis, which is similar to the billing frequency.

(footnote continued)

codified by SAB No. 103, *Update of Codification of Staff Accounting Bulletins* (Codification of Staff Accounting Bulletins, Topic 13, *Revenue Recognition*) as amended by SAB No. 104, *Revenue Recognition* (Codification of Staff Accounting Bulletins Topic 13—*Revenue Recognition*, Section A—*Selected Revenue Recognition Issues*).

Policy Acquisition Costs

3.35 As defined in the FASB ASC glossary, *acquisition costs* are costs incurred with the acquisition of new and renewal insurance contracts, and vary with and are primarily related to the acquisition of insurance contracts. As discussed in FASB ASC 944-30-25-1 and FASB ASC 944-30-35-1, acquisition costs should be capitalized and charged to expense in proportion to premium revenue recognized.

3.36 Examples of acquisition costs are commissions and other costs, such as salaries of certain employees involved in the underwriting and policy-issue functions, as well as premium taxes and inspection fees that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred.

3.37 As discussed in FASB ASC 944-30-35-2, if acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, should be applied to applicable unearned premiums throughout the period of the contracts.

3.38 The computation should be made by reasonable groupings of the entity's business in a manner consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance products.

3.39 Under SAP, acquisition costs are expensed as incurred.

Premium Deficiencies

3.40 A premium deficiency relating to short-duration insurance contracts indicates a probable loss on premiums yet to be earned. As discussed in FASB ASC 944-60-25-4, a premium deficiency should be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.

3.41 To determine if a premium deficiency exists, insurance contracts should be grouped consistently with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. As discussed in FASB ASC 944-60-25-5, a premium deficiency is recognized by first charging unamortized acquisition costs to expense to the extent required to eliminate the deficiency. As discussed in FASB ASC 944-60-50-1, disclosure is required about whether the insurance entity considers anticipated investment income in determining whether a premium deficiency relating to short-duration contracts exists. As discussed in FASB ASC 944-60-25-6, if the premium deficiency is greater than unamortized acquisition costs, a liability should be accrued for the excess deficiency.

3.42 Under SAP, SSAP No. 53 incorporates the same basic premise for determining a premium deficiency reserve but notes the following in paragraph 15, "Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings."

Accounting for Contracts That Do Not Transfer Insurance Risk

3.43 FASB ASC 340-30 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. As discussed in FASB ASC 340-30-05-2, the transfer of insurance risk requires transferring both timing risk and underwriting risk. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to as deposit accounting. FASB ASC 340-30 neither addresses when deposit accounting should be applied nor provides criteria to make that determination. This determination should be made on a case-by-case basis. The accounting by the insured and insurer are symmetrical, except as noted in FASB ASC 340-30-35-6 when contracts transfer only significant underwriting risk and if average rates are used as the discount rate for determining the deposit asset and liability.

3.44 As discussed in FASB ASC 340-30-25-1 and FASB ASC 340-30-30-1, at inception, a deposit asset or liability can be recognized for insurance or reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. As discussed in FASB ASC 340-30-45-1, deposit assets and liabilities should be reported on a gross basis, unless the right of setoff exists per FASB ASC 210-20.

3.45 FASB ASC 340-30 provides guidance about the measurement of the deposit asset or liability at subsequent reporting dates. The subsequent measurement of the deposits is based upon whether the insurance and reinsurance contract (*a*) transfers only significant timing risk, (*b*) transfers only significant underwriting risk, (*c*) transfers neither significant timing nor underwriting risk, or (*d*) has indeterminate risk.

3.46 Paragraphs 1–2 of FASB ASC 340-30-50 require the following disclosures:

a. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

b. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

   i. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses.

   ii. Any adjustments of amounts initially recognized for expected recoveries (The individual components of the adjustment [meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries] should be disclosed separately.)

   iii. The amortization expense attributable to the expiration of coverage provided under the contract.

3.47 Under SAP, guidance on accounting for contracts that do not transfer risk can be found in SSAP No. 52, *Deposit-Type Contracts*, which is generally the same principles as under generally accepted accounting principles. Structured settlements should be recorded consistent with the accounting provided for structured settlements in SSAP No. 65, *Property and Casualty Contracts*. Additional guidance can be found in SSAP No. 75, *Reinsurance Deposit Accounting—An Amendment of SSAP No. 62, Property and Casualty Reinsurance*.

Special Risk Considerations

3.48 To plan and carry out tests of transactions in the premium cycle, it is helpful for the auditor to understand the specific conditions that may increase the risks of error or fraud in the transactions and related account balances. These conditions may be peculiar to an individual entity's business practices, markets, products, or risk philosophies. This section provides examples of conditions that may indicate special risks in the premium cycle and that might be considered by the auditor in the audit. The factors considered in assessing risk should be evaluated in combination in making an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk.

3.49 The following are examples of conditions that may indicate special risks in the premium cycle:

- Rapid growth in premium volume
- New lines of business
- Changes in pricing or underwriting practices
- Premium deficiencies
- Distribution of products through the Internet

3.50 In evaluating the use of anticipated investment income in calculating a premium deficiency, the auditor may review the entity's cash flow assumptions and calculations based on anticipated claim payment patterns.

3.51 The auditor may find it necessary to use a specialist when evaluating areas included in the premium cycle, such as policy acquisition costs, loss ratios, and premium deficiencies. In these cases, refer to chapter 4, "The Loss Reserving and Claims Cycle," of this guide.

Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others

3.52 FASB ASC 310, *Receivables*, and FASB ASC 942, *Financial Services—Depository and Lending*, provides accounting guidance to any entity that lends to or finances the activities of others. The summary of significant accounting policies must include the basis for accounting for trade receivables, and the classification and method of accounting for other receivables. Receivables for property and liability entities include, but are not limited to, mortgage loans, agents' balances, premiums receivable, workers' compensation deductible recoveries, reinsurance recoverables, and securities on deposit with state insurance departments (which require financial statement disclosure). FASB ASC

310-10-50-9 requires that a description of the accounting policies and methodology the entity used to estimate its allowance for doubtful accounts be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments. In addition, FASB ASC 310-10-50-6 requires that the summary of significant accounting policies include the policy for charging off uncollectible trade receivables.

3.53 FASB ASC 310-10-50-2 requires disclosure of the method for recognizing interest income on loans, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs. FASB ASC 310-10-50-9 requires a description of the accounting policies and methodology the entity used to estimate its allowance for loan losses, allowance for doubtful accounts, and any liability for off-balance sheet credit losses and related charges for loan, trade receivables or other credit losses, which should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments.

3.54 Additionally, FASB ASC 310-10-50-6 requires that the summary of significant accounting policies include

- the policy for placing loans on nonaccrual status and recording payments received on nonaccrual loans, and the policy for resuming accrual of interest;
- the policy for charging off uncollectible loans; and
- the policy for determining past due or delinquency status.

FASB ASC 310-10-50-4 requires that the allowance for credit losses, and, as applicable, any unearned income, any unamortized premiums or discounts, and any net unamortized deferred fees and costs be disclosed in the financial statements. In addition, FASB ASC 310-10-50-7 requires the following to be disclosed in the notes to the financial statements: (*a*) that the recorded investment in loans on nonaccrual status as of each balance-sheet date and (*b*) the recorded investment in loans past due 90 days or more and still accruing. FASB ASC 310-10 contains other presentation and disclosure requirements that may apply to the financial statements of insurance entities. Refer to the full text of FASB ASC 310 and FASB ASC 942 when evaluating lending and financing activities of property and liability insurance enterprises.

Chapter 4

The Loss Reserving and Claims Cycle

Accounting Practices*

4.01 Sources for specialized industry accounting principles for insurance enterprises include Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*; FASB ASC 405-30; and FASB ASC 340-30.†

4.02 Under generally accepted accounting principles (U.S. GAAP), as discussed in paragraphs 1–2 of FASB ASC 944-40-25, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported (IBNR), are accrued when insured events occur. As discussed in of FASB ASC 944-40-30-1, the liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. As discussed in FASB ASC 944-40-30-2, estimated recoveries on unpaid claims, such as salvage, subrogation, or a potential ownership interest in real estate, should be evaluated in terms of their estimated realizable value, and deducted from the liability for unpaid claims. As discussed in FASB ASC 944-40-25-1, a liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. As discussed in FASB ASC 944-40-35-1, changes in estimates of the liabilities resulting from the continuous review process and differences between estimates and payments for claims should be recognized in income in the period in which the estimates are changed or payments are made. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because

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the time value of the money is taken into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public entities, the Securities and Exchange Commission (SEC) staff issued Codification of Staff Accounting Bulletins, Topic 5—*Miscellaneous Accounting*, Section N—*Discounting by Property/Casualty Insurance Companies* (formerly Staff Accounting Bulletin (SAB) No. 62, *Discounting by Property/Casualty Insurance Companies*), which discusses the appropriate accounting and financial reporting when an entity adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued Codification of Staff Accounting Bulletins Topic 5—*Miscellaneous Accounting*, Section W—*Contingency Disclosures Regarding Property/Casualty Insurance Reserves for Unpaid Claim Costs* (formerly SAB No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*), which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB ASC 450, *Contingencies*, and Codification of Staff Accounting Bulletins, Topic 5—*Miscellaneous Accounting*, Section Y—*Accounting and Disclosures Relating to Loss Contingencies*, Topic 10—*Utility Companies*, Section F—*Presentation of Liabilities for Environmental Costs* (formerly SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*), which provides the SEC staff's interpretation of current accounting literature relating to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liability, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Statutory Accounting Practices

4.03 Under statutory accounting practices (SAP), as noted in Statement of Statutory Accounting Principle (SSAP) No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, paragraph 4, "Claims, losses, and loss/claim adjustment expenses shall be recognized as expense when a covered or insured event occurs. . . . Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserve) and incurred costs, with a corresponding charge to income." Additional SAP guidance can be found in SSAP No. 62, *Property* *and Casualty Reinsurance*, and SSAP No. 65, *Property and Casualty Contracts*. SAP, which vary by state, are similar to U.S. GAAP for transactions in the claims cycle—estimated liabilities for unpaid claims, including IBNR and claim-adjustment expenses, are accrued when the insured events occur; however, there are certain differences. Under SAP, reinsurance recoverable on unpaid losses is deducted from the liability for unpaid claims.

4.04 As noted in SSAP No. 65 paragraph 10, "With the exception of fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted." The financial statements should disclose if the liabilities for unpaid losses or unpaid loss adjustment expenses (LAE) are discounted; see SSAP No. 65 paragraphs 14–15 for required disclosures.

4.05 For SAP, reinsurance recoverable balances are segregated for the purposes of determining the provision for reinsurance (the statutory reserve for uncollectible reinsurance) between those recoverable from entities authorized by the state to transact reinsurance and those recoverable from other entities, called unauthorized reinsurers. Under SAP, when reinsurance is placed with an unauthorized entity, which is therefore not subject to its jurisdiction and regulation, the ceding entity must maintain and report a liability account (or accounts) for reserve credits taken and the losses recoverable that have been recorded to the extent it has not retained funds or obtained letters of credit.

Types of Business and Their Effect on the Estimation Process

4.06 The reporting and payment characteristics of an entity's losses will differ depending on the types of policies written. Insurance policies may be categorized in several different ways:

- By policy duration (short-duration or long-duration)
- By type of coverage provided (occurrence basis or claims-made basis)
- By kind of insurance underwritten—in this chapter, the terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten (for example, property, liability, workers' compensation, and reinsurance)

Policy Duration

4.07 Insurance policies are considered to be either short-duration or long-duration. As discussed in FASB ASC 944-20-15-7, policies are considered short-duration when the contract provides for insurance coverage for a fixed period of short duration and enables the insurer to not renew the contract or adjust the provisions of the contract at the end of the contract period. As discussed in FASB ASC 944-20-15-10, policies are considered long-duration when the contract provides for insurance coverage for an extended period and is not generally subject to unilateral changes in its provisions. Because most policies written by property and liability insurance entities are short-duration policies, only short-duration contracts are considered in this chapter.

Type of Coverage

4.08 Insurance policies may be issued on either an occurrence basis or a claims-made basis. Occurrence-basis policies provide coverage for insured events occurring during the contract period, regardless of the length of time that passes before the insurance entity is notified of the claim. Under occurrence-basis policies, claims may be filed months or years after the policy contract has expired, making it difficult to estimate the eventual number of claims that will be reported. Theoretically, a pure claims-made policy only covers claims reported to the insurer during the contract period; however, in practice, claims-made policies generally cover claims reported to either the insurer or the insured during the contract period. As a result, claims may be reported to the insurer after the contract expires. Even if claims have been reported to the insurer during the contract period, it may take several months for the insurer to investigate and establish a case reserve for reported claims. In practice, most claims-made insurance policies contain extended reporting clauses or endorsements that provide for coverage, in specified circumstances, of claims occurring during the contract period but reported after the expiration of the policy. In many states, a claims-made insurance policy is required to (*a*) contain an extended-reporting clause, (*b*) provide for the purchase, at the policyholder's option, of *tail coverage*, that is, coverage for events occurring during the policy term but reported after the initial policy expires, or (*c*) provide for automatic tail coverage upon the death, disability, or retirement of the insured. Thus, in practice, claims-made policies can resemble occurrence-basis policies. If a claims-made insurance policy provides for coverage of claims incurred during the policy period but reported to the insurer after the end of the policy period, loss reserve requirements for such claims need to be considered.

Kind of Insurance Underwritten, Line of Business, or Type of Risk

4.09 The kind of insurance underwritten by property and liability insurance entities may be broadly categorized into five classes of coverage: property, liability, workers' compensation, surety, and fidelity. Additionally, policies may be written as primary coverage or reinsurance assumed.

4.10 Claims can be further classified as primary or reinsurance. Primary coverage involves policies written between an insurer and a customer directly. Reinsurance coverage involves the transfer of the insurer's risk to a reinsurer (see chapter 6, "Reinsurance"). Retrocession (sometimes also called *reinsurance*) involves the further transfer of the reinsurer's risk to a retrocessionaire (sometimes also called a *reinsurer*). Excess claims are those in which another insurer or the insured pays a significant portion of the claim amount (called a *retention*) before the excess coverage responds. Retentions can be thousands of dollars or millions of dollars, depending on the situation.

4.11 Property claims generally are reported and settled quickly, often within several months. Some exceptions to this general rule are coverages known as business interruption insurance and ocean marine insurance. Property claims usually are first-party claims, that is, they are direct obligations of the insurer to pay the insured, with the claimant being the policyholder. In addition, the occurrence and the extent of property losses are relatively easily determinable because the claims relate to tangible property. The processing of property claims is often streamlined through bulk reserving or small-claim procedures in which many small claims are summarized and aggregated.

4.12 Liability claims are reported more slowly than property claims, and settlement is often delayed, especially if litigation is involved. Liability claims are third-party claims in which the insurer has agreed to pay, defend, or settle claims made by third parties against the insured. A single insured event may result in several claimants. In processing a liability claim, many entities keep a single file for each insured event, with separate identification of each claimant.

4.13 Workers' compensation claims are reported quickly, and some claims are settled slowly. The amount of most claim payments is set by law and may change during the life of a claim. A claim settlement is characterized by numerous payments to the claimants or survivors for medical expenses and loss of earnings, possibly over extended periods of time.

4.14 In some instances, surety or fidelity claims may be reported and settled very slowly because the loss may be discovered months or years after it has occurred. Determining the extent of the loss also often takes a long time. Financial guarantee insurance has become a significant insured risk to some entities. Financial guarantees include the guaranteeing of interest and principal payments on corporate and municipal debt, the guaranteeing of limited partnership obligations, and a number of other products in which the insurance entity takes on an obligation to pay at some later date. The ultimate exposure to a large loss can be high with financial guarantees.[‡]

4.15 Some lines of insurance are commonly referred to as *long-tail* lines because of the extended time required before claims are ultimately settled. Examples of long-tail lines are automobile bodily injury liability, workers' compensation, professional liability, and other lines such as products and umbrella. Lines of insurance in which claims are settled relatively quickly are called *short-tail* lines. It is generally more difficult to estimate loss reserves for long-tail lines because of the long period that elapses between the occurrence of a claim and its final disposition, and the difficulty of estimating the settlement value of the claim.

The Transaction Cycle

4.16 Although specific procedures vary from entity to entity, there is a common pattern to the flow of transactions through the claims cycle, which consists of the following major functions: claim acceptance and processing, claim adjustment and estimation, claim settlement, and loss reserve evaluation.

Claim Acceptance and Processing

4.17 Notice of a loss or accident is received at the home or branch office directly from the insured or through agents. A file number for the claim, which forms the basis for all future references, is assigned to the case, usually in numerical sequence, and a loss file and abstract are prepared. Policy applications or other records of insurance coverage are examined to determine whether the loss is covered by the insurance policy and whether the policy was in force at the time the loss occurred. Questions of coverage are usually raised when the case is new. Failure to raise questions promptly may be prejudicial to an entity's rights. If it appears that the claim is covered, the case is assigned to an adjuster. Some entities establish a diary file instead of a claim file when a notice of an

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[‡] See footnote † on accounting guidance for financial guarantee insurance contracts.

incident is received and the entity is not certain that the facts require them to establish a claim file and record an estimate. For example, an insured under a liability policy may report an injury but the injury is not expected to result in a claim. The diary file items may be referred to as precautionary claims in the context of excess claims.

4.18 Claim file face sheets containing abstracts of coverage and loss notices are prepared along with information for later use in the development of statistics used for reserve analysis and product pricing. In addition to the line of business classification, claims are classified by state, location of risk, date of loss, and policy year. Coding of claims data is important because errors in coding data directly affect the reliability of information used to report historical claims experience as well as analyses of current claim obligations, which the entity and the auditor use to evaluate the adequacy of loss reserves. Among the most important dates that might affect loss reserve developments are the accident date, policy effective date, claim reporting date (date reported to entity), claim recording date (date the claim is entered on the entity's computer recording system), claim payment date, and claim reopening date (there may be more than one reopening date). Claims data must also be properly coded to meet the statutory reporting requirements of the annual statement and to provide statistics to support rate filings.

4.19 Smaller and "one-shot" claims are processed by less expensive methods. Usually a claim file is not prepared, and a separate reserve estimate is not recorded. All statistical and accounting matters are processed on the date of payment, and average reserve estimation methods are used between the report and settlement dates.

Claim Adjustment and Estimation

4.20 Claims adjusting involves (*a*) a field investigation, (*b*) an appraisal and negotiation of the claim subject to the appropriate supervision, and (*c*) approval by the entity's claims department. Through an investigation, the adjuster determines, among other things, whether the claimed loss actually occurred, his or her estimate of the amount of the loss, whether the loss may be excludable under the terms of the policy, and whether the entity has a right to recover part or all of the loss through salvage, or subrogation. Salvage is a contractual right of recovery that entitles the insurer to any proceeds from the disposal of damaged property for which the claim has been paid, such as the sale of a wrecked automobile to a junkyard. Subrogation is the legal right of the insurer to recover from a third party who may be wholly or partly responsible for the loss paid under the terms of the policy, such as recovery from an employee for the employer's loss covered by a fidelity bond.

4.21 Insurance entities use several different methods to adjust claims. Entities may use home or branch office adjusters, who are salaried employees of the entity, or independent adjusters, who are professionals who charge fees for their investigation and adjustment service. Insurance entities may also join together to form an adjustment bureau to which they may refer claims. Subject to certain limitations, an adjustment bureau acts for each member entity in the adjustment and negotiation of claims, with the entity retaining the final authority for approval. Expenses of the adjustment bureau are shared among members, usually based on the number or dollar volume of claims referred to the bureau for adjustment. Most entities use a combination of methods to adjust claims. They may have a claim branch office established for closer supervision and better control of the cost of adjustments in territories in which they have a larger concentration of risks. In the territories in which their business does not warrant the establishment of a claim branch office, they may use independent adjusters or join an adjustment bureau.

4.22 As soon as practicable, an adjuster estimates the total expected amount that is payable on a claim. Such an estimate may be determined by the average cost per case based on experience for the line of business, or may be based on specific information on the individual case. The estimate is revised in response to changes in experience or as investigations progress and further information is received.

4.23 Entities have different approaches to establishing reserves on individual claim files. For some entities the case reserve represents the amount the entity would pay as a settlement based on the facts in the file at that time. Reserves based on that approach tend, in the aggregate, to be inadequate to pay the ultimate cost of the reported claims. For other entities, the claim reserve represents a worst-case view of the injury and the liability or coverage issues presented by the case. Reserves based on this approach tend, in the aggregate, to exceed the ultimate cost of the reported claims.

4.24 For most entities, the philosophy intended for individual claim reserving falls between the examples described previously. For purposes of establishing an appropriate financial statement reserve, the most important factors to consider are (*a*) the historical adequacy or inadequacy of total reserves, (*b*) the consistency in the reserving approach followed by the entity, and (*c*) the availability of an actuarial or statistical analysis of reserves.

4.25 High jury awards, malpractice claims, structured settlements, and the proliferation of mass tort and latent injury claims, such as those for injuries caused by the environment and asbestos, have complicated the claim estimation process. Structured settlements potentially allow entities to ultimately pay lesser amounts on claims by purchasing annuities to pay settlements to claimants over future periods. The structured settlement allows an entity to eliminate the reserve that was recorded for the claim, even if it exceeded the amount paid for the settlement. However, if the structured settlement is made to the claimant with recourse, the insurer is ultimately liable and should account for the structured settlement as reinsurance receivable from a retroactive reinsurance contract. Mass tort and latent injury claims have affected entities indirectly through their participation in pools and associations, such as the significant reserves that the industry had to provide for black-lung claims. The advent of such claims has resulted in utilizing a variety of higher level reviews, such as those by claims committees and in-house counsel.

Claim Settlement

4.26 Claim and claim expense payments originate with signed proofs of loss, releases, medical bills, repair bills, or invoices for fees of independent adjusters or lawyers. When these documents are received, they are reviewed and compared with the claim files before payment is authorized. Authorized payments are then posted to the face sheets.

4.27 Methods of payment vary among insurance entities. Approved documents may be forwarded to the cashier for draft or check preparation, or the claim department may have authority to issue drafts. In many entities, authority to issue drafts may be given to field offices, adjusters, and sometimes agents; in those cases, copies of the drafts and related supporting documents are forwarded to the claims department. After processing, the supporting documents are filed in the related claim files.

4.28 Some entities record claims paid by checks or drafts when issued. Other insurance entities record claims paid when the drafts clear the bank. Source records are then forwarded to the data processing department for entry, usually in controlled batches, and totals of paid losses are posted to the general ledger. Changes in payment procedures or changes in the definition of payment date for coding purposes can affect loss reserve developments.

4.29 The treatment of structured settlements is different between SAP and U.S. GAAP. SSAP No. 65 paragraph 18 states "Statutory accounting and generally accepted accounting principles (GAAP) are consistent for the accounting of structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the owner and payee and the reporting entity has been released from its obligation. GAAP distinguishes structured settlement annuities where the owner is the claimant and a legally enforceable release from the reporting entity's liability is obtained from those where the claimant is the owner and payee but the reporting entity had not been released from its obligation. GAAP requires the deferral of gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the reporting entity has not been released from its obligation. Statutory accounting treats these settlements as completed transactions and considers the earnings process complete, thereby allowing for immediate gain recognition." Also see paragraph 19 of SSAP No. 65 for disclosure items for structured settlements.

Reinsurance Receivable

4.30 Upon receiving a notice of a claim, the claims department in conjunction with the reinsurance department generally determines whether there is any right of recovery under a reinsurance agreement. Daily reports show pro rata reinsurance information. Recoveries under quota-share reinsurance agreements are usually based on total claims figures period by period. Excess reinsurance is determined by claims adjusters based on reinsurance contracts. Reinsurance arrangements on liability policies may include provisions such that if aggregate claims from a common occurrence exceed a retention, then the excess amounts are covered by the reinsurer. Recoveries under such aggregate excess reinsurance treaties are coded similarly to catastrophe claims. (Chapter 6 describes reinsurance contracts.)

4.31 When it is determined that there will be reinsurance receivable on a claim, the estimated amount receivable is usually recorded in the claim file and the data processing records. Notices of losses are sent to the reinsurers in accordance with terms of the reinsurance contracts. Although some reinsurance contracts contain provisions for immediate recovery for losses over a stated amount, recoveries are normally settled monthly or quarterly, sometimes by being deducted from the premiums due to the reinsurers.

Salvage and Subrogation

4.32 After a claim has been settled, the possibility of salvage or subrogation may exist. Perhaps the simplest approach to determining the anticipated receivable is to estimate loss reserves using loss data that is net of salvage and subrogation recoveries. Many of the reserving methods for losses and loss-adjustment expenses, however, can also be used to estimate salvage and subrogation recoveries.

Claims Transaction Flow

4.33 The claims transaction flow in an insurance entity is summarized as follows:

a. The insured reports the loss to his or her agent or directly to the entity. If the insuring entity has a central loss-reporting facility, the agency instead places the insured in contact with the facility, which will obtain the details of the loss from the insured and prepare a loss report. Insurance entities usually have separate departments to handle such claims; larger entities may even have separate departments to handle each kind of claim.

b. The loss is assigned a claim number and entered, either manually or through IT media, on the entity's loss register. Claim numbers are generally assigned sequentially or by policy number.

c. A file is established to accumulate pertinent data and correspondence.

d. Concurrent with establishing a file, a copy of the policy (called the daily) under which the claim is being made is examined to determine the amount of coverage and whether the claimant was, at the time of occurrence, insured against the kind of loss suffered. The copy of the daily may be included in the claim file for further reference and documentation.

e. An adjuster is assigned to investigate the loss. The adjuster may be an employee of the insurance entity, its agent, or an independent professional. The adjuster helps determine the amount of loss, estimate the reserve required, and provide information such as photographs, police reports, medical reports, statements of witnesses, and any other pertinent items to substantiate the loss.

f. A reserve (case outstanding) is established for the estimated dollar amount of loss that will ultimately be paid on the claim. Reserves are difficult to estimate because in some cases the severity of a loss or the effects of injuries, which may become apparent at some future time, are not readily subject to current determination. Many entities have minimum, maximum, or average amounts of reserves established for reported claims derived from their experience of past claim settlements.

g. Reinsurance applicable to the claim is reviewed, and reinsurance-receivables are established if the claim is subject to the terms of a reinsurance agreement; if necessary, the reinsurers are notified. If salvage or subrogation rights may be available, the appropriate notation and controls should also be posted.

h. After negotiation with the claimant, a check or draft is issued for the amount of the adjusted claim. On receipt of payment, the claimant generally signs a release indicating that final settlement has been received.

i. If reinsurance applies, loss payments receivable are posted to the appropriate control for summary reporting to the reinsurers or, if necessary, a proof of loss requesting payment is prepared and forwarded to the reinsurers.

Components of Loss Reserves

4.34 Loss reserves are an insurer's estimate of its liability for the unpaid costs of insured events that have occurred. An insurance entity's loss reserves consist of one or more of the components described subsequently. All of these components should be considered in the loss-reserving process but may not have to be separately estimated:

- *Case-basis reserves*. The sum of the values assigned by claims adjusters to specific known claims that were recorded by the insurance entity but not yet paid at the financial statement date. This chapter describes the most common methods used by entities to establish case-basis reserves.
- *Case-development reserves*. The difference between the case-basis reserves and the estimated ultimate cost of such recorded claims. This component recognizes that case-basis reserves, which are estimates based on incomplete or preliminary data, will probably differ from ultimate settlement amounts. Accordingly, a summation of case-basis reserve estimates may not produce the most reasonable estimate of their ultimate cost.
- *IBNR*. The estimated cost to settle claims arising from insured events that occurred but were not reported to the insurance entity as of the financial statement date. This component includes reserves for bulk provisions or claims *in transit*, that is, claims reported to the entity but not yet recorded and included in the case-basis reserve. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves.
- *Reopened-claims reserve*. The cost of future payments on claims closed as of the financial statement date that may be reopened due to circumstances unforeseen at the time the claims were closed.

Sometimes, case-development reserves, IBNR, and the reopened-claims reserve are calculated as a single reserve and broadly referred to as IBNR. In addition to the basic components of loss reserves, an entity will also need to estimate the effect of the following components:

- *Reserves for LAE*. Expected payments for costs to be incurred in connection with the adjustment and recording of losses. SSAP No. 55 paragraph 5 notes that LAE can be classified as "Defense and Cost Containment (DCC) and Adjusting and Other (AO). DCC includes defense, litigation, and medical cost containment expenses, whether internal or external. AO are those expenses other than DCC. . . . And include but are not limited to the following items: (*a*) Fees and expenses of adjusters and settling agents, (*b*) Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year, (*c*) Attorney fees incurred in the determination of coverage, including litigation between the reporting entity and the policyholder; and (*d*) Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster."

- *Reduction for salvage*. The estimated amount receivable by the insurer from the disposition of damaged or recovered property. Potential salvage on paid and unpaid losses generally should be considered in this estimate.
- *Reduction for subrogation*. The estimated amount receivable from third parties from whom the insured may have the right to recover damages. The insured, having collected benefits from the insurer, is required to subrogate such rights to the insurer.
- *Drafts outstanding*. Some insurance entities may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.
- *Reserves for assessments based on paid losses*. The estimated amount of future assessments relating to payments on losses incurred prior to the financial statement date. An example is assessments by state workers' compensation second-injury funds.[1] In practice some entities included such assessments as losses, and others record them as taxes. SSAP No. 35, *Guaranty Fund and Other Assessments*, requires that entities record changes in the reserve in taxes, licenses and fees.
- *Reinsurance receivables*. Amounts that will be recovered from reinsurers for losses and LAE accrued, including IBNR losses accrued. As stated in FASB ASC 944-310-45-5, amounts receivable from reinsurers on paid and unpaid losses shall be classified as assets.

4.35 Many insurance entities do not separately value each of the reserve components listed previously. Frequently, an insurance entity's reserve for case development is combined with its reserve for IBNR claims. Reinsurance and other recoveries may be netted against claim payments in the insurance entity's records. In those situations, initial reserve estimates are also net of recoveries; separate analysis is then performed to determine the appropriate amount to record as the reinsurance receivable asset. DCC may be combined with loss payments and included in these components.

Estimating Methods

4.36 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical

[1] FASB ASC 405-30 provides guidance on accounting by insurance and other enterprises for assessments used to fund second-injury funds.

analyses of historical experience and are commonly referred to as loss reserve projections.

4.37 Loss reserve projections are used to develop loss reserve estimates. Understanding and assessing the variability of these estimates and the reliability of historical experience as an indicator of future loss payments generally require management to make careful analysis of the historical loss data and the use of projection methods that are sensitive to the particular circumstances.

4.38 The data used for projections is generally grouped by line of business and may be further classified by attributes such as geographic location, underwriting class, or type of coverage to improve the homogeneity of the data within each group. The data is then arranged chronologically. The following are dates that are key to classifying the chronology of the data:

- *Policy date*. The date on which the contract becomes effective (also referred to as the underwriting date).
- *Accident date*. The date on which the accident (or loss) occurs.
- *Report date*. The date on which the entity first receives notice of the claim.
- *Record date*. The date on which the entity records the claim in its statistical system.
- *Closing date*. The date on which the claim is closed.

4.39 After the data has been grouped by line of business and by chronology, it may then be arrayed to facilitate the analysis of the data, highlight trends, and permit ready extrapolation of the data. The following are examples of types of data that are commonly arrayed and analyzed:

- Losses paid
- Losses incurred
- Case reserves outstanding
- Claim units reported
- Claim units paid
- Claim units closed
- Claim units outstanding
- DCC paid
- DCC outstanding
- Salvage and subrogation recovered
- Reinsurance recovered
- Reinsurance receivable
- Premiums earned
- Premiums in force
- Exposures earned
- Policies in force

4.40 The data may be cumulative or incremental, gross or net of reinsurance, gross or net of salvage and subrogation, or combined with DCC data. The data may be stratified by size of loss or other criteria. Because claim data and characteristics such as dates, type of loss, and claim counts significantly affect reserve estimation, controls should be established over the recording, classification, and accumulation of historical data used in the determination of loss reserves. Exhibit B-1 in appendix B of this guide presents examples of such control activities.

4.41 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models. Projection methods basically fall into three categories:

- Extrapolation of historical loss dollars
- Projection of separate frequency and severity data (the number of claims that will be paid or closed and the average costs of these claims)
- Use of expected loss ratios

4.42 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

4.43 Following is a brief summary of some commonly used projection methods.

Method	*Basis*
Loss Extrapolation	
Paid loss	Uses only paid losses. Outstanding case reserves are not considered.
Incurred loss	Uses paid losses plus reserves on outstanding claims.
Average Severities	Uses various claim count and average cost per claim data on either a paid or incurred basis.
Loss Ratio	Uses various forms of expected losses in relation to premiums earned.

4.44 The decision to use a particular projection method and the results obtained from that method generally should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of these assumptions to the circumstances. Stability and consistency of data are extremely important. Changes in variables, such as rates of claim payments, claim department practices, case-basis reserving adequacy, claim reporting rates, mix of business, reinsurance retention levels, and the legal environment, may have a significant effect on the projection and may produce distortions or conflicting results. For more information, refer to the section in this chapter titled "Changes in the Environment" (paragraphs 4.63–.66) for a discussion of how changes in variables may affect the loss-reserving process. The results of any projection normally should be reviewed for reasonableness by analyzing the resultant loss ratios and losses per measure of exposure.

Illustrative Projection Data

4.45 The following tables are simple illustrations of the use of the loss extrapolation method to estimate ultimate losses, as well as the effects of considering the results of more than one projection. In these illustrations, the result of extrapolating incurred-loss data is compared with the result of extrapolating paid-loss data. These tables are presented solely for the purpose of illustrating the mathematical mechanics of the two projections. They do not illustrate the required analysis of the data, and consideration of internal and external environmental variables that may affect the claim payment and loss reserving process.

4.46 Table 4-1 presents an illustration of historical incurred-loss data. It reflects, as an example, that the sum of paid losses and case reserves outstanding at the end of 20X0 was $2,054; that sum increased to $2,717 in the next year and increased to $3,270 5 years later.

4.47 This incurred-loss data is first used to calculate historical period-to-period incurred-loss development factors. These factors are used to compare the amount of incurred losses at successive development stages, and are illustrated in table 4-2 part 1.

4.48 The calculation of average historical period-to-period incurred-loss development factors may be based on the use of simple averages of various period-to-period factors or may be based on more complex weighting or trending techniques. These techniques can significantly affect the reserve estimation process and normally require judgment, understanding, and experience. In this example, a simple average of the latest three period-to-period factors has been calculated and is presented in table 4-2 part 2.

Table 4-1

Case-Basis Incurred-Loss Data as of 12/31/X9

	Development Period (in months)									
Accident Year	*12*	*24*	*36*	*48*	*60*	*72*	*84*	*96*	*108*	*120*
20X0	$2,054	$2,717	$2,979	$3,095	$3,199	$3,348	$3,270	$3,286	$3,299	$3,301
20X1	2,213	2,980	3,269	3,461	3,551	3,592	3,631	3,643	3,651	
20X2	2,341	3,125	3,513	3,695	3,798	3,849	3,872	3,876		
20X3	2,492	3,502	3,928	4,177	4,313	4,369	4,392			
20X4	2,964	4,246	4,859	5,179	5,315	5,376				
20X5	3,394	4,929	5,605	5,957	6,131					
20X6	3,715	5,433	6,162	6,571						
20X7	4,157	5,912	6,771							
20X8	4,573	6,382								
20X9	4,785									

4.49 Once historical period-to-period incurred-loss development factors are calculated, future period-to-period incurred-loss development factors must be selected. The future period-to-period factors must reflect anticipated differences between historical and future conditions that affect loss development, such as changes in the underlying business, different inflation rates, or case-basis reserving practices. In the example, no differences are anticipated and the average historical factors have been chosen as the selected factors as shown in table 4-2 part 2. The selected future period-to-period factors are then used to produce ultimate incurred development factors. The ultimate factors are presented in table 4-2 part 3.

Table 4-2

Period-to-Period Incurred-Loss Development Factors as of 12/31/X9

	Development Period (in months)									
Accident Year	*12-24*	*24-36*	*36-48*	*48-60*	*60-72*	*72-84*	*84-96*	*96-108*	*108-120*	*Est. Tail*[1]
Part 1: Period-to-Period Historical Loss Development Factors										
20X0	1.323[2]	1.096	1.039	1.034	1.047	0.977	1.005	1.004	1.001	
20X1	1.347	1.097	1.059	1.026	1.012	1.011	1.003	1.002		
20X2	1.335	1.124	1.052	1.028	1.013	1.006	1.001			
20X3	1.405	1.122	1.063	1.033	1.013	1.005				
20X4	1.433	1.144	1.066	1.026	1.011					
20X5	1.452	1.137	1.063	1.029						
20X6	1.462	1.134	1.066							
20X7	1.422	1.145								
20X8	1.396									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Selected Factors										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Part 3: Ultimate Development Factors Selected for the Projection										
	1.828[3]	1.281	1.125	1.056	1.026	1.014	1.007	1.004	1.001	1.000

[1] Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.000 in this illustration).

[2] The 24-month developed losses are divided by the 12-month developed losses from table 4-1 ($2,717/$2,054 = 1.323).

[3] The product of the remaining factors (1.427 x 1.139 x 1.065 x 1.029 x 1.012 x 1.007 x 1.003 x 1.003 x 1.001 x 1.000 = 1.828) or the product of the 12–24 selected factor times the 24–36 ultimate factor (1.427 x 1.281 = 1.828).

4.50 The loss reserve analysis has now reached the point where an initial projection of ultimate losses, as well as an indicated provision for unreported losses for each accident year, can be made by using the historical incurred-loss data and the ultimate incurred-loss development factors. This initial projection of ultimate losses is presented in table 4-3.

4.51 Table 4-4 presents paid-loss data for the same entity whose incurred-loss data was presented in table 4-1. The array of paid-loss period-to-period development factors presented in table 4-5 is derived from table 4-4 using the same calculation methods used for incurred losses in table 4-2. The importance of the use of a tail factor in this calculation is apparent from the period-to-period historical loss development factors calculated in table 4-5. The tail factor represents an estimate of the development of losses beyond the period covered by the data array. In this instance, a tail factor of 1.01 was selected to project an additional 1 percent of losses to be paid from the tenth development year to ultimate. Selection of a tail factor requires careful judgment based on consideration of entity and industry experience for the line of business, actuarial studies, case reserves, and any other relevant information.

4.52 The initial projection of ultimate losses, using the historical paid losses and the paid-loss ultimate development factors, is presented in table 4-6.

4.53 Table 4-7 compares the results of extrapolating paid-loss data (table 4-6) with the results of extrapolating incurred-loss data (table 4-3).

4.54 Although all accident periods should be analyzed and trends evaluated, it is clear that additional analysis of accident year 20X9 losses is required. The difference between the results obtained from the 2 different projections is significant. Initial inspection will trace the source of the difference to the high level of losses paid in 20X9 for accident year 20X9 relative to case-basis incurred losses for the same period. The loss reserving analysis must focus on whether the increase in payments represents an acceleration of payment activity or an increase in the overall level of losses incurred in 20X9. The benefit of using more than one projection is that it allows for this kind of analysis and comparison in the evaluation of loss reserves.

Table 4-3

Incurred-Loss Projection as of 12/31/X9

Accident Year	*Case-Basis Incurred Loss as of 19X9*[1]	*Ultimate Incurred-Losses Development Factors*[2]	*Projected Ultimate Losses (2) × (3)*	*Projected Unreported Loss (4) − (2)*
(1)	(2)	(3)	(4)	(5)
20X0	$ 3,301	1.000	$ 3,301	$ 0
20X1	3,651	1.001	3,655	4
20X2	3,876	1.004	3,892	16
20X3	4,392	1.007	4,423	31
20X4	5,376	1.014	5,451	75
20X5	6,131	1.026	6,290	159
20X6	6,571	1.056	6,939	368
20X7	6,771	1.125	7,617	846
20X8	6,382	1.281	8,175	1,793
20X9	4,785	1.828	8,747	3,962
Total	$51,236		$58,490	$7,254

[1] From table 4-1.

[2] From table 4-2 part 3.

Table 4-4

Paid-Loss Data as of 12/31/X9

Accident Year	*Development Period (in months)* 12	24	36	48	60	72	84	96	108	120
20X0	$896	$1,716	$2,291	$2,696	$3,041	$3,096	$3,185	$3,235	$3,262	$3,276
20X1	872	1,840	2,503	2,973	3,261	3,429	3,538	3,589	3,624	
20X2	968	1,975	2,683	3,185	3,494	3,670	3,763	3,819		
20X3	968	2,130	2,968	3,571	3,942	4,147	4,274			
20X4	1,201	2,580	3,673	4,421	4,860	5,114				
20X5	1,348	2,996	4,207	5,115	5,632					
20X6	1,340	3,146	4,520	5,496						
20X7	1,384	3,428	4,960							
20X8	1,568	3,696								
20X9	2,243									

Table 4-5

Period-to-Period Paid-Loss Development Factors as of 12/31/X9

Accident Year	*Development Period (in months)* 12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Est. Tail[1]
Part 1: Period-to-Period Historical Loss Development Factors[2]										
20X0	1.915	1.335	1.177	1.128	1.018	1.029	1.016	1.008	1.004	
20X1	2.110	1.360	1.188	1.097	1.052	1.032	1.014	1.010		
20X2	2.040	1.358	1.187	1.097	1.050	1.025	1.015			
20X3	2.200	1.393	1.203	1.104	1.052	1.031				
20X4	2.148	1.424	1.204	1.099	1.052					
20X5	2.223	1.404	1.216	1.101						
20X6	2.348	1.437	1.216							
20X7	2.477	1.447								
20X8	2.357									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Selected Factors										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Part 3: Ultimate Development Factors Selected for the Projection[2]										
	5.127	2.142	1.499	1.237	1.123	1.069	1.039	1.023	1.014	1.010

[1] Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.010 in this illustration).

[2] Computations are the same as those explained in table 4-2.

Table 4-6

Paid-Loss Projection as of 12/31/X9

Accident Year	*Paid Losses as of 20X9*	*Ultimate Loss Development Factors*	*Projected Ultimate Losses (2) × (3)*	*Projected Unreported Losses*[1]
(1)	(2)	(3)	(4)	(5)
20X0	$ 3,276	1.010	$ 3,309	$ 8
20X1	3,624	1.014	3,675	24
20X2	3,819	1.023	3,907	31
20X3	4,274	1.039	4,439	47
20X4	5,114	1.069	5,465	89
20X5	5,632	1.123	6,325	194
20X6	5,496	1.237	6,796	225
20X7	4,960	1.499	7,434	663
20X8	3,696	2.142	7,916	1,534
20X9	2,243	5.127	11,500	6,715
Total	$42,134		$60,766	$9,530

[1] Represents the projected losses from table 4-6 column 4, less the recorded case-basis incurred losses from table 4-3 column 2.

Table 4-7

Alternative Projections of Ultimate Losses and Unreported Losses as of 12/31/X9

Accident Year	*Ultimate Losses*		*Unreported Losses*	
	Incurred	*Paid*	*Incurred*	*Paid*
20X0	$ 3,301	$ 3,309	$ 0	$ 8
20X1	3,655	3,675	4	24
20X2	3,892	3,907	16	31
20X3	4,423	4,439	31	47
20X4	5,451	5,465	75	89
20X5	6,290	6,325	159	194
20X6	6,939	6,796	368	225
20X7	7,617	7,434	846	663
20X8	8,175	7,916	1,793	1,534
20X9	8,747	11,500	3,962	6,715
Total	$58,490	$60,766	$7,254	$9,530

Loss Adjustment Expense Reserves

4.55 LAE reserves are the costs that will be required to settle claims that have been incurred as of the valuation date. As explained in paragraph 4.34, LAE can be classified into 2 broad categories: DCC and AO.

DCC Reserve Calculation Approaches

4.56 DCC is generally analyzed by line of business. A shift in the composition of the costs in relation to the total might affect the statistical data used in the related loss projections. This shift would need to be considered in future loss reserve projections.

4.57 Many entities calculate DCC reserves based on the relationship of DCC to losses. Underlying this approach is a basic assumption that DCC will increase or decrease in proportion to losses. The setting of reserves for DCC based on the relationship of paid DCC to paid losses is referred to as the *paid-to-paid ratio* approach. Separate ratios are normally developed for each accident year. Inflation in DCC is not typically evaluated separately; rather, it is estimated to occur at the same rate as the rate of inflation in the losses. The validity of this assumption can be tested by reviewing historical relationships between DCC and losses over time. The effects of a pattern of increasing or decreasing ratio of DCC to losses should be considered in establishing DCC reserves. An understanding of the claim department's operations and philosophy over time is essential to a proper interpretation of the data.

4.58 Other approaches to DCC reserve calculation and analysis include (*a*) analyzing DCC entirely apart from the related loss costs using methods that compare the development of DCC payments at various stages and (*b*) using combined loss and DCC data in situations where it appears likely that this would produce more accurate estimates (for example, when the entity has changed its claim defense posture so that defense costs increase and loss costs decrease). In this latter approach, statistical tests and projections are based on the combined data for losses and DCC.

4.59 Some entities establish case-basis reserves for certain types of DCC or increase case-basis loss reserves by a stated percentage to provide for DCC. In either case, additional DCC reserves should be provided for the development of case-basis reserves and IBNR.

AO Reserve Calculation Approaches

4.60 AO reserves are often provided for by using the calendar year paid-to-paid method rather than the accident year paid-to-paid method used for DCC reserves. Although the paid-to-paid ratios establish the relationship of the AO payments to the loss payments, the timing of the AO payments is also critical to estimation of the AO reserves. For example, some entities assume that a portion of AO costs is incurred when a claim is placed on the books and the remaining portion is incurred when the claim is settled. For reported claims, the cost of placing the claim on the books has been incurred, so it is only necessary to provide a reserve for the remaining portion at settlement. For IBNR claims, it is necessary to provide for all of the AO. Some entities perform internal studies to establish the methods and ratios to be used in their calculations.

4.61 The AO reserves normally provide for inflation. The assumption that AO will inflate at a rate equal to the rate at which losses inflate generally should be periodically reviewed. The rate is normally adjusted for expected technological or operational changes that might cause economies or inefficiencies in the claim settlement process.

4.62 If paid-to-paid AO ratios will be calculated for each line of business, a reasonable basis for allocating paid AO by line of business should be established.

Changes in the Environment

4.63 Loss reserve projections are used to estimate loss reporting patterns, loss payment patterns, and ultimate claim costs. An inherent assumption in such projections is that historical loss patterns can be used to predict future patterns with reasonable accuracy. Because many variables can affect past and future loss patterns, the effect of changes in such variables on the results of loss projections should be carefully considered.

4.64 Identification of changes in variables and consideration of their effect on loss reserve projections are critical steps in the loss reserving process. The evaluation of these factors requires the involvement of a loss reserve specialist as well as input from various operating departments within the entity such as the marketing, underwriting, claims, actuarial, reinsurance, and legal departments. Management's use of a specialist in determining loss reserves is discussed in paragraphs 4.67–.70 of this chapter.

4.65 Variables to be considered in evaluating the results of loss reserve projections include variables affecting inherent and control risk. If changes in variables have occurred, mechanical application of loss projection methods may result in unreasonable estimates of ultimate claim costs. Changes in variables can be considered in the loss reserving process in a variety of ways, including

- *selection of loss projection method(s)*. Loss projection methods vary in their sensitivity to changes in the underlying variables and to the length of the claim emergence pattern. When selecting a loss projection method, consideration should be given to how a change in the underlying data will affect that method. For example, if management has adopted a policy to defer or accelerate the settlement of claims, a paid-loss extrapolation method will probably produce unreliable results. In that case, an incurred-loss extrapolation or other methods may produce better estimates of ultimate losses.
- *adjustment of underlying historical loss data*. In certain cases, the effect of changed variables can be isolated and appropriately reflected in the historical loss data used in the loss projection. For example, if policy limits are relatively consistent for all policies in a block of business, and if these limits have recently been reduced by a constant amount, historical loss data can be adjusted to exclude amounts in excess of the revised policy limits.
- *further segregation of historical loss data*. Certain changes in variables can be addressed by further differentiating and segregating historical loss data. For example, if an entity begins to issue claims-made policies for a line of business for which it traditionally issued occurrence-basis policies, segregation of data between the two types of policies normally should minimize the effect of the different reporting patterns. Such segregation generally should produce more accurate loss reserve projections for the occurrence-basis policies. (However, loss development data relating to the claims-made policies will be limited in the initial years.)
- *separate calculation of the effect of variables*. The effect of certain changes in variables can be isolated and separately computed as an adjustment to the results of other loss projection methods. For

example, if claim cost severity has increased (an increase in auto repair costs) or is expected to increase beyond historic trends, an additional reserve can be separately computed to reflect the effect of such actual or anticipated increases.

- *qualitative assessments*. In many instances, the magnitude or effect of a change in a variable will be uncertain. The establishment of loss reserves in such situations generally requires considerable judgment and knowledge of the entity's business.

The development of environmental and similar claims may not follow the usual development pattern of general liability claims, with which they are usually grouped. When the activity of these claims is sufficient to distort the recorded development of the entity, the distorting activity should be isolated from the development history so that an accurate projection of the remaining claims can be made. Management's process of assessing its environmental and similar exposure could include procedures to

- ensure that all data elements are recorded on each incoming claim or precautionary notice.
- assess the entity's exposure to these types of liability claims by considering such factors as the types of risks historically written, layers of coverage provided, the policy language employed, and recent decisions rendered by courts.
- determine whether any portion of potential liability costs is probable and reasonably estimable.

4.66 FASB ASC 450 provides guidance for the accounting and disclosure of loss contingencies.

Use of Specialists by Management in Determining Loss Reserves

4.67 Management is responsible for making the accounting estimates included in the financial statements. As explained in the previous sections of this chapter, the process of estimating loss reserves is complex and involves many subjective judgments. Accordingly, the determination of loss reserves should involve an individual with a sufficient level of competence and experience in loss reserving, including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of appropriate methods available for calculating loss reserve estimates. These individuals are referred to as *loss reserve specialists* in this chapter. The specialist's level of competence and experience should be commensurate with the complexity of the entity's business, which is affected by such factors as the kind(s) of insurance underwritten and environmental and risk considerations. Criteria that may be considered in determining whether an individual qualifies as a loss reserve specialist include the aforementioned as well as the following:

- Knowledge of various projection techniques, including their strengths and weaknesses and applicability to various lines of insurance
- Knowledge of changes in the environment in which the entity operates, including regulatory developments, social and legal trends, court decisions, and other factors described in more detail in the

appendix and the effect that these factors will have on the emergence and ultimate cost of these claims

4.68 The Casualty Actuarial Society offers a course of study and examinations that are designed to train individuals to be, among other things, loss reserve specialists. In addition, the American Academy of Actuaries establishes qualification standards for its members who practice in this area. Although many casualty actuaries may therefore be qualified to be loss reserve specialists, other individuals, through their experience and training, may also be qualified. Training and experience might provide individuals with knowledge about different policy forms and coverages, current developments in insurance, and environmental factors that might affect the loss reserving process. Training and experience might also provide individuals with knowledge that will enable them to apply appropriate methods of estimating loss reserves. The extent of this knowledge and ability should be commensurate with the complexity and kinds of business written.

4.69 Many insurance entities use loss reserve specialists who are employees or officers of the entity. In addition, many entities engage consulting casualty actuaries to either assist in the determination of the loss reserve estimate or to perform a separate review of the entity's loss reserve estimate. The scope of work to be performed by the consulting actuary is a matter of judgment by entity management. Usually, the consulting actuary will issue a report summarizing the nature of the work performed and the results. Since 1990, the annual statement instructions have required a Statement of Actuarial Opinion relating to loss and LAE reserves.

4.70 Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimate may constitute a significant deficiency and possibly a material weakness in the entity's internal control. AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit*, describes the auditor's responsibility to communicate significant deficiencies to the audit committee. For an integrated audit, AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), describes the auditor's responsibilities regarding communication. Additionally, under National Association of Insurance Commissioners (NAIC) requirements discussed in paragraph 4.75, management must coordinate and require the CPA to subject actuarial data to testing procedures. Discussion of the auditor's use of loss reserve specialists is also included in additional sections throughout this chapter, including paragraphs 4.82, 4.84, and 4.112–.115. Additionally, see paragraph 4.115 for guidance about the performance of nonaudit services by auditors.

Guaranty Fund and Other Assessments

4.71 State guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance enterprises. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies and (*b*) to fund second-injury funds. FASB ASC 405-30 provides guidance on U.S. GAAP accounting for guaranty-fund and other assessments related to insurance activities, and SSAP No. 35, *Guaranty Fund and Other Assessments*, provides SAP.

Auditing Loss Reserves

Auditing the Claims Database

4.72 The historical experience of an insurance entity is generally the primary source of information on which loss reserve estimates are based; therefore, the creation of reliable databases, within an insurance entity, is extremely critical to the determination of loss reserve estimates. When evaluating loss reserves, the auditor should consider the reliability of the historical information generated by the insurance entity.

4.73 The auditor should determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of the loss data.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]). Also refer to paragraph 54 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for a discussion on the extent of tests of controls.

4.74 Additionally, the auditor should identify and assess the risks of material misstatement for relevant assertions about loss reserves. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as a basis to determine the nature, timing, and extent of further audit procedures. Regardless of the audit approach selected, the auditor should perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.[2] The auditor's substantive procedures should include agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and

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[2] For integrated audits, the sentence reads "Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures."

examining material journal entries and other adjustments. Because claim data and characteristics such as dates and type of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data. Exhibit B-1 in appendix B of this guide provides more extensive guidance on auditing the claims cycle.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> For audits performed in accordance with PCAOB standards, the auditor's substantive procedures must include reconciling the financial statements to the accounting records and should include examining material adjustments made during the course of preparing the financial statements (paragraph .19 of AU section 326, *Evidential Matter* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]).

4.75 The *NAIC Property and Casualty Annual Statement Instructions* require coordination among the auditor, an appointed actuary, and management and potentially require additional procedures for the auditor related to claim loss and LAE data. Section 9 of the instructions, "Scope of Examination and Report of Independent Certified Public Accountant," states:

> The insurer shall also require that the independent certified public accountant subject the data used by the appointed actuary to testing procedures. The auditor is required to determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of loss data and perform testing as to the understanding of the controls related to the completeness, accuracy, and classification of loss data, and perform other testing as the auditor deems appropriate. Through inquiry of the appointed actuary, the auditor should obtain an understanding of the data identified by the appointed actuary as significant. It is recognized that there will be instances when data identified by the appointed actuary as significant to his or her reserve projections would not otherwise have been tested as part of the audit, and separate testing would be required. Unless otherwise agreed among the appointed actuary, management, and the auditor, the scope of the work performed by the auditor in testing the claims data in the course of the audit would be sufficient to determine whether the data tested is fairly stated in all material respects in relation to the statutory financial statements taken as a whole. The auditing procedures should be applied to the claims loss and defense and cost containment expense data used by the appointed actuary and would be applied to activity that occurred in the current calendar year (for example, tests of payments on claims paid during the current calendar year).

This does not replace the requirements to audit reconciliations of the data provided in Schedule P of the annual statement to the underlying accounting records. The auditor should inform management if the auditor has not planned to include in the audit all of the data identified as significant by the appointed actuary, that there may be a need for additional testing outside the scope of the statutory audit. The conclusion regarding the need for the auditor to perform additional procedures should be agreed with management, after discussion with the appointed actuary. If procedures are performed beyond those included in the statutory audit, the auditor should report on such work under the AICPA *Professional Standards.*[3]

Evaluating the Reasonableness of the Estimate

Selecting an Audit Approach

4.76 AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. The loss reserve estimate is a significant estimate on the financial statements of an insurance entity. Accordingly, regardless of the approach used to audit the loss reserve estimate, the auditor should gain an understanding of how management developed the estimate. The auditor could use one or a combination of the following approaches in evaluating the reasonableness of the accounting estimates:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

Considerations for Audits Performed in Accordance with PCAOB Standards

When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the 3 approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decision about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate (paragraph .10 of AU section 342, *Auditing Accounting Estimates* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]).

4.77 When auditing loss reserve estimates, usually approach *a*, *b*, or a combination of the two is used. Normally, approach *c* alone is insufficient to provide reasonable assurance because claims are usually reported to insurance entities and settled over a period of time extending well beyond a normal opinion date. However, approach *c* may provide additional information concerning the reasonableness of loss reserve estimates, particularly for short-tail lines of business, when used in combination either with approach *a* or *b* or with both.

4.78 When planning the audit, the auditor chooses to use either approach *a* or *b*, or a combination of both approaches, depending on his or her expectation of

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[3] The American Academy of Actuaries Committee on Property & Liability Financial Reporting published a paper in October 2004 titled "Data Testing Requirement in 2004 P/C Annual Statement Instructions: Guidance For Actuaries Signing Statements of Actuarial Opinions on Loss and Loss Expense Reserves." The paper can be found on the American Academy of Actuaries website www.actuary.org.

what approach will result in sufficient appropriate audit evidence in the most cost-effective manner. Either approach can be used and, depending on client circumstances, either approach may be effective. However, when management has not used the services of a loss reserve specialist in developing its loss reserve estimate, approach *a*, reviewing and testing management's process, is not appropriate. In this circumstance, approach *b*, developing an independent expectation, should be used.

Reviewing and Testing the Process Used by Management to Develop the Estimate

4.79 The auditor may assess the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. This approach may be appropriate when loss reserve estimates are recommended by an outside loss reserve specialist and management accepts those recommendations, when loss reserve specialists employed by the entity are responsible for recommending the estimates, or when both outside and internal specialists are used.

4.80 An entity that uses an outside loss reserve specialist to develop loss reserve recommendations may engage the specialist to evaluate only the entity's major lines of business or only certain components of the loss reserves. In either circumstance, the auditor may determine that a different approach is needed for auditing the items not reported on by the loss-reserve specialist.

4.81 If the auditor reviews and tests the process used by management to develop its estimate, and management's estimate differs significantly from the recommendations developed by its specialists, appropriate procedures could be applied to the factors and assumptions that resulted in the difference between management's estimate and the specialists' recommendations. Such procedures could include discussion with management and its specialists. It is management's responsibility to record its best estimate of loss reserves in the financial statements.

4.82 AU section 342 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) identifies the following as procedures the auditor may consider performing when using this approach. Some of the procedures listed subsequently apply to the process management uses to supply data to the loss reserve specialist, some apply to the process used by the specialist to develop recommendations, some apply to the process used by management to review and evaluate those recommendations, and some apply to the process management uses to translate the specialist's recommendations into the loss reserve estimates recorded in the financial statements:

- *Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.* Controls over the preparation of accounting estimates may include
  - — procedures for selecting independent loss reserve specialists or hiring internal specialists, including procedures for determining that the specialist has the requisite competence in loss reserving, knowledge of the entity's types of business, and understanding of the different methods available for calculating loss reserve estimates.

- — procedures for reviewing and evaluating the recommendations of the loss reserve specialist.
- — procedures to ensure that the methods used to calculate the loss reserve estimate are appropriate and sufficient in the circumstances.

Controls over the preparation of supporting data, in addition to those discussed in exhibit B-1 in appendix B of this guide, may include

- — procedures for verifying that data used by the loss reserve specialist is appropriately summarized and classified from the entity's claims database.
- — procedures for ensuring that data actually used by the loss reserve specialist is complete and accurate.
- — procedures to substantiate and determine the appropriateness of industry or other external data sources used in developing assumptions (for example, data received from involuntary risk pools).

- *Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests.* Sources of data and factors used may include

  - — entity historical claims data from its own databases, including changes and trends in the data.
  - — entity information on reinsurance levels and changes from prior years' reinsurance programs.
  - — data received from involuntary risk pools such as those administered by the National Council on Compensation Insurance.
  - — industry loss data from published sources.
  - — internal entity experience or information from published sources concerning recent trends in socioeconomic factors affecting claim payments, such as (*a*) general inflation rates and specific inflation rates for medical costs, wages, automobile repair costs, and the like; (*b*) judicial decisions assessing liability; (*c*) judicial decisions regarding noneconomic damages; and (*d*) changes in legislation affecting payment levels and settlement practices.

  Consider whether the entity's data is sufficient to have adequate statistical credibility (for example, to allow the "law of large numbers" to work for the entity's estimates). Consider whether the types of industry data used in developing assumptions are relevant to the entity's book of business, considering policy limits, reinsurance retention, geographic and industry concentrations, and other appropriate factors.

- *Consider whether there are additional key factors or alternative assumptions about the factors.* Key factors and potential alternative assumptions that might be considered include

- changes in the entity's experience or trends in loss reporting and settlements. Increases in the speed of the settlement of claims may lead to assumptions that paid development levels will be lower in the future, or may indicate changes in the entity's procedures for processing claims that could lead to increased development in the future.
- divergence in entity experience relative to industry experience. Such divergence might later result in entity development experience that reduces the divergence or might be indicative of a change in an entity's experience with a book of business.
- changes in an entity's practices and procedures relating to recording and settling claims.
- an entity's reinsurance programs and changes therein.
- changes in an entity's underwriting practices such as new or increased use of managing general agents.
- new or changed policy forms or coverages.
- recent catastrophic occurrences.

• *Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.* Assumptions that should be evaluated include not only explicit assumptions but also the assumptions inherent in various loss projection methods:

  - Paid loss projection methods assume that an entity's historical experience relating to the timeliness of settlement will be predictive of future results.
  - Reported (incurred) loss development projection methods assume that an entity's experience in estimating case-basis reserves will be repeated in the future.

• *Analyze historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and consider whether the data is sufficiently reliable for the purpose.* Consider whether the entity's past methods of estimating loss reserves have resulted in appropriate estimates and whether current data (for example, current-year development factors) indicate changes from prior experience. Consider how known changes in the entity's loss reporting procedures and settlement practices have been factored into the estimate. Consider how changes in reinsurance programs, in the current period and during historical periods, have been factored into management's estimates.

• *Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.* Consider such changes as

  - new lines of business and classes of business within lines.
  - changes in reinsurance programs.

— changes in the regulatory environment, such as premium rate rollbacks and regulation.

— changes in the method of establishing rates and changes in methods of underwriting business.

- *Review available documentation of the assumptions used in developing the accounting estimates, inquire about any other plans, goals, and objectives of the entity, and consider their relationship to the assumptions.* An entity's practices concerning loss settlement, such as a practice of vigorously defending suits or of quickly settling suits, can have a significant effect on an entity's loss experience.

- *Consider using the work of a specialist regarding certain assumptions.* Using the work of a specialist is discussed in AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), and in paragraphs 4.112–.115 of this chapter.

- *Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.* Consider whether all lines of business and accident years are included in the loss reserve estimate. Consider how reinsurance receivable, salvage, and subrogation have been included.

Developing an Independent Expectation of the Estimate

4.83 Based on his or her understanding of the facts and circumstances, the auditor may independently develop an expectation of the estimate by using other key factors or alternative assumptions about those factors. This approach is required whenever management has not used the services of a loss reserve specialist in developing its loss reserve estimate and may be appropriate to assist the auditor in assessing the variability of the loss reserve estimates, even when management does use a loss reserve specialist. The auditor frequently develops independent projections because this method may result in a more cost-effective method of obtaining sufficient appropriate audit evidence.

4.84 When this approach is used, the auditor may use an outside loss reserve specialist (the auditor may also be a loss reserve specialist) to develop the independent expectation of the loss reserve estimate. The use of a specialist is discussed in paragraphs 4.112–.115 of this chapter.

Analytical Procedures[4]

4.85 Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. A basic premise underlying the application of analytical procedures is that it is reasonable to assume that plausible relationships among data exist and continue in the absence of known conditions to the contrary. Variations in these relationships may be caused by particular conditions such as unusual transactions or events,

[4] The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures. The Audit Guide includes a discussion of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), concepts and definitions, a series of questions and answers, and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis.

accounting changes, material business changes, random fluctuations, or misstatements.

4.86 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use and documentation of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. Also, in accordance with paragraph .09 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the auditor should apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit.

4.87 Analytical procedures may be effective and efficient tests for assertions even though an examination of detailed evidence fails to disclose potential misstatements or detailed evidence is not readily available. Examples of sources of information for developing analytical expectations include prior-period financial information, Insurance Regulatory Information System ratio analysis, and rating agency reports. Specific documentation requirements exist for when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

4.88 Various analytical procedures may be used in the evaluation of loss reserve trends and data, such as the analysis of

- loss ratios.
- loss frequency and severity statistics.
- claim cost by exposure units.
- adequacy or redundancy of prior year reserves.
- average case reserves.
- claim closure rates.
- paid to incurred ratios.

4.89 Such analyses include comparison of trends and data with industry averages or other expectations. Evaluation would normally be performed by line of business and accident or report year.

4.90 When designing analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

Loss Reserve Ranges

4.91 As stated in AU section 342 (AICPA, *Professional Standards*, vol. 1), estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take. Accordingly, loss reserves may develop in a number of ways and a reserve for a particular line of business or accident year may prove to be redundant or deficient when analyzed in a following period. Loss reserves considered to be adequate in prior periods may need to be adjusted at a later date as a result of events outside the control of the insurance entity that create the need for a change in estimate. Such events include future court decisions and periods of inflation, in which rates may change significantly from period to period and affect the payout of claims. As a result of the circumstances described previously, the need to adjust loss reserve estimates in future periods because of future events that are not predictable at the balance sheet date should not be interpreted as evidence of an error or poor loss reserving practices in the past.

4.92 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. Auditors should refer to AU section 342 (AICPA, *Professional Standards*, vol. 1) when considering the inherent variability of loss reserve estimates and the effect of that variability on the risk of material misstatement. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst-case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range).

4.93 Another way to address the variability of the loss reserve estimate is to develop a best estimate and to supplement it with qualitative analysis that addresses the variability of the estimate. Qualitative analysis involves consideration of the factors affecting the variability of loss reserves and integrating such factors into a determination of the range of reasonable estimates around a best estimate. Such factors, among others, include the mix of products underwritten, losses incurred by the insurance industry for similar coverages and underwriting years, and the correlation between past and current business written. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors. The audit procedures performed for this purpose will vary based on the characteristics of the business, the controls the entity uses to monitor such variability, and other audit procedures used.

4.94 The size of the loss reserve range will vary by line of business. For example, automobile physical damage claims may be estimated with greater precision than product liability claims. In extreme cases, the top-to-bottom range could extend to 50 percent and upward of the amount provided. An example of an extreme case might be a newly formed entity that writes primarily volatile types of business. The results of operations in such a situation are sensitive to future fluctuations because the loss reserve estimate is based primarily on assumptions that will undoubtedly change over time. More important, however, is the strain that any extremely adverse loss development would place on such an entity's surplus. In an opposite extreme case, the top-to-bottom range might only be 5 percent of the amount provided for an entity that only writes automobile physical damage coverages.

4.95 In evaluating whether management has identified all accounting estimates that could be material to the financial statements, the auditor considers the circumstances of the industry or industries in which the entity operates, its methods of conducting business, new accounting pronouncements, and other external factors. In other words, it is unlikely that ultimate claim settlements for each line of business will fall at the same end of the range.

Risk Factors and Developing a Range

4.96 Because loss reserves represent both reported and unreported claims that have occurred as of the valuation date, the auditor needs to gain an understanding of the entity's exposure to risk through the business it writes as well as an understanding of environmental factors that may affect the entity's loss development at the valuation date.

4.97 Some risk factors existing within the entity that may affect the variability of the entity's loss reserves are

- *the frequency and severity of claims associated with a line of business*. Medical malpractice, directors' and officers' liability, and other lines of business that typically produce few claims with large settlement amounts tend to have a high degree of variability.
- *policy characteristics*. Individual lines of business can be written on different policy forms. For example, loss reserving and its related variability for medical malpractice written on an occurrence basis will differ markedly when the policy is written on a claims-made basis, especially during the early years of conversion from an occurrence to a claims-made basis.
- *retention levels*. The greater an entity's retention level, the more variable the results are likely to be. This increased variability is due to the effect that one or several large losses can have on the overall book of business. For reinsurance assumed, the concepts analogous to retention levels are referred to as attachment points and limits.
- *the mix of an entity's business with respect to long-tail liability lines and short-tail property lines.* Typically, loss reserves on business with longer tails exhibit greater variability than on business with shorter tails because events affecting ultimate claim settlements may occur at a later date.

4.98 Some external factors that may affect the variability of loss reserves are

- catastrophes or major civil disorders.
- jury awards and social inflation arising from the legal environment in principal states in which an entity's risks are underwritten.
- the effect of inflation.

4.99 The auditor should obtain an understanding of both internal and external risk factors. This may be accomplished by a review of contracts, inquiries of underwriters, a review of pertinent trade publications, and any other procedures deemed necessary under the circumstances. The auditor should consider these factors in evaluating a reasonable loss reserve range. The best estimate may not necessarily be midway between the highest and lowest estimates in the range, because certain factors (for example, risk retention limits and retrospectively rated contracts) may reduce the variability at one end of the range but not at the other.

4.100 When analyzing the variability of loss reserves, the auditor should be aware of potential offsets that may serve to reduce the financial statement effects of misstatements in the recorded loss reserves. Two common examples are ceded reinsurance and retrospectively rated contracts (primary or reinsurance). Such offsets, if material, should be included in an analysis of reserve ranges to quantify the true income statement or balance sheet effect that results from an increase or decrease in loss reserves.

4.101 As noted previously in the discussion of internal risk factors and per-risk retention levels, a lower net retention level typically would translate into a lower variability of reserves. In addition, the auditor should consider the workings of all significant reinsurance ceded contracts and the effect that these contracts have on best estimates and high and low points in a range. In considering the effect of reinsurance ceded agreements on loss reserves, the auditor should also consider the effect on ceded reinsurance premiums. See paragraphs 4.109–.121 of this chapter for a discussion of the effects of ceded reinsurance on loss reserve estimates.

4.102 A retrospectively rated feature in an insurance contract means that increases or decreases in incurred losses may be wholly or partially offset by changes to earned but unbilled premiums. As a result of such a clause, an increase in loss reserves may lead to a receivable for additional premiums, and a decrease in loss reserves may be offset by a reduction in premiums.

Evaluating the Financial Effect of a Reserve Range

4.103 To determine the amount of variability that is significant to the financial statements, the financial leverage of an entity should be analyzed. Financial leverage refers to items such as reserve-to-surplus ratios. The financial position of an entity with a 2-to-1 reserve-to-surplus ratio is less affected by variability in its loss reserves than is an entity operating at a 4-to-1 ratio.

4.104 Additionally, an analysis comparing the difference between recorded loss reserves and the high and low ends of a range with key financial statement balances, such as surplus or recorded loss reserves, might be performed. Combining financial leverage with other materiality factors pertinent to the entity (for example, loan covenant agreements) may provide insights into the amount of variability that is acceptable to the auditor. Because of the imprecise nature of estimating loss reserves, the acceptable range of loss reserve estimates will generally be higher than that of a more tangible balance such as accounts receivable or payable.

4.105 According to paragraph .56 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), ". . . if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement." Therefore, if the recorded loss reserve is outside a range of realistic estimates, the difference between the recorded reserve and the nearer end of the reasonable reserve range would be aggregated as a likely misstatement. As stated in paragraph .42 of AU section 312, the auditor must communicate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Where the auditor has identified a likely misstatement involving differences in estimates, the auditor should request management to review the assumption and methods used in developing the estimate. After management has challenged the assumptions and methods used in developing an estimate for which the auditor has identified a likely misstatement, the auditor should reevaluate the amount of the likely misstatement. This includes performing additional further audit procedures, if necessary. If management decides not to correct the misstatements communicated to it by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that into account when considering the qualitative aspects of the entity's accounting practices and the implications for the auditor's report.

4.106 AU section 312 states that materiality judgments involve both qualitative and quantitative considerations. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. Refer to paragraph .69 of AU section 312 for documentation requirements related to misstatements

Considerations for Integrated Audits

For audits conducted in accordance with PCAOB standards, PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes general requirements for documentation the auditor should prepare and retain in connection with applicable engagements.

4.107 Paragraph .56 of AU section 312 also states, "Because no one accounting estimate can be considered accurate with certainty, the auditor may determine that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may not be significant, and such difference would not be considered to be a likely misstatement." Accordingly, if the recorded loss reserve is within the reasonable range developed by the auditor, an audit adjustment may not be appropriate.

4.108 The significance of the variability within a reasonable reserve range should also be evaluated against the financial statements. If the difference between the entity's recorded reserve and the farther end of the reserve range is deemed significant, the auditor might extend audit procedures to obtain additional audit evidence relating to the reserve estimate.

4.109 Management generally should select a single loss reserve estimate that represents its judgment about the most likely circumstances and events. If management develops a reasonable range, the amount recorded could be the best estimate within that range. The auditor should obtain an understanding of the process used by management in arriving at this estimate. In determining the reasonableness of loss reserves, the auditor also might consider the consistency of reserve estimates and any changes in the degree of conservatism of recorded reserves. A change in the degree of conservatism of management's estimate may be indicative of a change in management's reserve process. AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1), discusses the auditor's responsibility to consider whether the financial statements include adequate disclosure of material matters in light of the circumstances and facts of which the auditor is aware.

4.110 When performing an integrated audit, additional guidance relating to audit risk and materiality can be found in AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). Note that an integrated audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness (paragraph .05 of AU section 312).

Auditor Uncertainty About the Reasonableness of Management's Estimate and Reporting Implications

4.111 Ordinarily, the auditor would look to historical data to obtain audit evidence that will provide reasonable assurance that management's estimate of loss reserves is reasonable in the circumstances. Such historical data may not currently exist for certain new entities, for entities writing significant amounts of new lines of business, or for entities with a low volume of claims. When the historical data is not sufficient to resolve uncertainty about the reasonableness of management's estimate of loss reserves and the auditor is unable to resolve that uncertainty through other means, the auditor could make a determination whether management has adequately disclosed the uncertainty in the notes to the financial statements as required by FASB Statement No. 5, *Accounting for Contingencies*, and paragraphs 4 and 6 of FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss—an interpretation of FASB Statement No. 5*, and Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640). A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive audit evidence concerning its outcome would be expected to become available. Conclusive audit evidence concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related audit evidence are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the audit evidence supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient audit evidence supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient audit evidence to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient audit evidence related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

Use of Specialists by Auditors in Evaluating Loss Reserves

4.112 It is the auditor's responsibility to evaluate the reasonableness of the loss reserve established by management. AU section 342 (AICPA, *Professional Standards*, vol. 1) provides guidance for use by an auditor when considering the reasonableness of the loss reserve. One of the procedures the auditor may consider in evaluating the reasonableness of the loss reserve is using the work of a specialist. AU section 336 provides guidance to the auditor who uses the work of a specialist in performing an audit of financial statements. It states that the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. The statement also states that the auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. Although AU section 336 does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of loss reserves to the financial statements of insurance entities and the complexity and subjectivity involved in making loss reserve estimates, the audit of loss reserves requires the use of an outside loss reserve specialist, that is, a specialist who is not an employee or officer of the entity. The term *loss reserve specialist* is defined in paragraphs 4.67–.68 of this chapter. See paragraph 4.115 for guidance about the performance of nonaudit services by auditors.

4.113 In accordance with AU section 336, whenever the auditor uses the work of a specialist, the auditor should fulfill certain fundamental requirements. The auditor should satisfy himself or herself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures. The auditor also should consider the relationship, if any, of the specialist to the client. An understanding should be established between the auditor, the client, and the specialist as to the scope and nature of the work to be performed by the specialist and the form and content of the specialist's report. The auditor has the responsibility to obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings of the specialist are suitable for corroborating representations in the financial statements. These responsibilities apply to all the situations described in paragraph 4.114.

4.114 The following are descriptions of situations involving the presence or absence of a loss reserve specialist in management's determination of loss reserves and the recommended response by the auditor in each situation.

Situation 1—The entity has no loss reserve specialist involved in the determination of loss reserves.

Auditor response to situation 1—As stated in paragraph 4.70, this situation may constitute a significant deficiency and possibly a material weakness in internal control. The auditor should use an outside loss reserve specialist to develop an independent expectation of the loss reserve estimate recorded by the entity.

Situation 2—The entity has an in-house loss reserve specialist who is involved in the determination of loss reserves and the entity does not use an outside loss reserve specialist.

Auditor response to situation 2—The auditor would be required to use an outside loss reserve specialist to evaluate the reasonableness of the entity's loss reserve estimate.

Situation 3—The entity has no in-house specialist but involves an outside loss reserve specialist in the determination of loss reserves.

Auditor response to situation 3—The auditor should evaluate the relationship, if any, of the specialist to the entity. If the specialist is related to the client, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or consider the use of an outside specialist for that purpose.

Situation 4—The entity involves an in-house loss reserve specialist in the determination of loss reserves and involves an outside loss reserve specialist to separately review the loss reserves.

Auditor response to situation 4—The auditor could use the separate review performed by the outside loss reserve specialist.

4.115 Prohibitions and restrictions exist related to the performance of nonaudit services for audit clients, including certain actuarial services. Practitioners should be aware of and comply with these prohibitions and restrictions, including the AICPA independence rules (Interpretation No. 101-3, "Performance of nonattest services," of Rule 101, *Independence* [AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05]), SEC independence rules, PCAOB independence rules, as well as rules passed by Government Accountability Office, state licensing boards, and others. State insurance regulators and the NAIC are independently considering whether certain provisions of the Sarbanes-Oxley Act of 2002, including prohibition against the auditing firm providing internal audit, accounting and actuarial services, should be adopted by all insurance entities. Practitioners should be alert to developments in this area.

Evaluating the Reasonableness of Loss Adjustment Expense Reserves

4.116 Evaluation of the reasonableness of LAE reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves; therefore, such an evaluation ordinarily requires the use of an outside loss reserve specialist. Frequently, both DCC reserves and AO reserves are calculated based on formulas related to paid losses; therefore, in conjunction with the audit of LAE, the auditor should perform sufficient procedures to obtain assurance about the reliability of the paid-loss data. (See paragraph 4.75 for further details.) Although DCC and AO frequently are calculated using formulas based on paid losses, they are calculated differently; accordingly, different procedures are used in the evaluation of these 2 types of reserves.

4.117 In most circumstances, a development test cannot be used as a test of the reasonableness of the AO reserve. The reasonableness of the AO reserve is primarily dependent on the application of sound techniques of cost accounting and expense allocation. The basis of this allocation should be reviewed by the auditor because the way that the entity allocates its expenses will have an effect on the AO reserve calculation. This review should focus on the allocation of costs to the loss adjustment classification as well as the allocation within that classification to the individual lines of business.

Ceded Reinsurance Receivable

4.118 This section discusses certain concepts and procedures that the auditor should be aware of to make a proper evaluation of the reasonableness of reinsurance receivable. This section does not address the following items, which are discussed in chapter 6. Refer to chapter 6 of this guide for information about

- the purpose and nature of reinsurance.
- forms and types of reinsurance.
- U.S. GAAP for reinsurance transactions.
- internal control considerations relating to ceded and assumed reinsurance and a description of audit procedures to verify the integrity of recorded transaction data pursuant to such agreements.

Understanding an Insurance Entity's Reinsurance Program

4.119 Chapter 6 of this guide recommends that the auditor obtain an understanding of an insurance entity's reinsurance program to properly perform audit procedures to verify the accuracy and completeness of recorded cessions and assess the ability of reinsurers to meet their financial obligations under such agreements. This understanding is also essential to properly evaluate the reasonableness of reinsurance receivable balances. The scope of this understanding should not be limited to the reinsurance program currently in effect but should also include reinsurance program(s) in effect during historical periods from which loss experience will be used to project current year ultimate losses and reinsurance recoveries.

4.120 Net loss development patterns will vary to the extent that current reinsurance arrangements (coverages, levels of retention, and type and form of reinsurance) differ from arrangements in effect during the claim experience period used to project losses. Accordingly, the effect of such differences on estimates of reinsurance receivables will need to be carefully assessed by the auditor. The level of complexity involved in making this assessment is largely dependent on the types of reinsurance used and the amount of experience available under the program.

4.121 Special difficulties arise in estimating reinsurance receivable on excess of loss reinsurance arrangements in which claim frequency is sporadic, retention levels have changed, or aggregate excess of loss arrangements are used. Estimates of reinsurance receivables are generally easiest for primary first dollar coverages (first dollar coverage of either property or casualty business). Additionally, relying on expected loss ratios as a guide for estimating recoveries on excess reinsurance arrangements will not be very helpful if the pricing of such arrangements has varied from year to year with little correlation to the underlying economics of these agreements. Some entities separately project reinsurance receivable on IBNR losses by stratifying the data base by size of loss.

Disclosures[5] of Certain Matters in the Financial Statements of Insurance Enterprises

Applicability to Statutory Financial Statements

4.122 Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .60–.77), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP. Provisions of the NAIC *Accounting Practices and Procedures Manual* or any other explicit rejection of a GAAP disclosure do not negate the requirements of AU section 623. However, the manual and NAIC Emerging Accounting Issues Working Group Interpretation 04-1, *Applicability of New GAAP Disclosures Prior to NAIC Consideration*, state that GAAP pronouncements do not become part of SAP until and unless adopted by the NAIC. For further information, see exhibit 1-1, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," in chapter 1, "Nature, Conduct, and Regulation of the Business."

Relationship to Other Pronouncements

4.123 In some circumstances, the disclosure requirements in FASB ASC 944 may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by FASB, AICPA, or the SEC. For example,

- FASB ASC 450 requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance entities.
- FASB ASC 275, *Risks and Uncertainties*, requires certain disclosures about reinsurance transactions.
- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.[6]

Conclusions

4.124 The disclosure requirements in this section should be read in conjunction with "Illustrative Disclosures" (paragraphs 4.133–.136).

Permitted Statutory Accounting Practices

4.125 The insurance laws and regulations of the states require insurance entities domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law. The NAIC codified SAP for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual*. All states

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[5] See paragraph 2.112, paragraphs 1.54–.56, and the preface of this guide for additional information on rules and regulations.

[6] For additional information, see paragraph 1.53.

require insurers to comply with most, if not all, provisions of the manual. Auditors of insurance enterprises should monitor the status of the adoption of the manual by the various state regulatory authorities.

4.126 Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. A state may adopt the manual in whole, or in part, as an element of prescribed SAP. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed SAP applicable in each state.

4.127 Permitted SAP include practices not prescribed by the domiciliary state as described in paragraph 4.127 but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice, or (*b*) if prescribed SAP do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from entity to entity within a state, and may change in the future. For additional information see paragraphs 1.75–.78.

4.128 The disclosures in this paragraph should be made if (*a*) state prescribed SAP differ from NAIC SAP or (*b*) permitted state SAP differ from either state prescribed SAP or NAIC SAP. The disclosures should be made if the use of prescribed or permitted SAP (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC SAP been followed. If an insurance entity's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed SAP or NAIC SAP.[7]

Liability for Unpaid Claims and Claim Adjustment Expenses

4.129 As discussed in FASB ASC 944-40-25-1, both of the following shall be accrued when insured events occur:

1. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer)

[7] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority, and their monetary effects.

2. A liability for claim adjustment expenses; that is a liability for all costs expected to be incurred in connection with the settlement of unpaid claims.

As discussed in FASB ASC 944-40-25-2, the estimated liability includes the amount of money that will be used for future payments of (*a*) claims that have been reported to the insurer and (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated. As discussed in FASB ASC 944-40-25-3, claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

4.130 As discussed in FASB ASC 944-40-50-3, financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

d. The reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects[8]

4.131 In addition to the disclosures required by FASB ASC 450, paragraphs 1 and 4 of FASB ASC 944-40-50 note that insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental exposures.

Illustrative Disclosures

4.132 The following illustrations are guides to implementation of the disclosures required by FASB ASC 944. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of FASB ASC 944.

Prescribed or Permitted Statutory Accounting Practices

4.133 Following are 2 examples of illustrative disclosures that an insurance enterprise could make to meet the requirements of FASB ASC 944.

[8] For additional information, see paragraph 1.53.

Note X. *Statutory Accounting Practices*

The company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its SAP, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $2.5 million and $2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The company's statutory capital and surplus, including the effects of the permitted practice, was $30.0 million and $27.9 million at December 31, 20X2 and 20X1, respectively.

Had the company amortized its goodwill over 10 years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the company's capital and surplus would have been $29.9 million and $27.7 million at December 31, 20X2 and 20X1, respectively.[1]

Note X. *Statutory Accounting Practices*

The company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its SAP, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of the [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department is as follows:

	December 31	
	20X2 *$m*	*20X1* *$m*
Statutory capital and surplus per statutory financial statements	$30.0	$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [state of domicile's] prescribed practice of immediate write-off of goodwill [2]	2.4	2.1
Statutory capital and surplus in accordance with the National Association of Insurance Commissioners statutory accounting practices[3]	$29.9	$27.7

[2] This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate.

[3] In the initial year of implementation of this disclosure, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed.

Liability for Unpaid Claims and Claim Adjustment Expenses

4.134 The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph 4.131. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

Note X. *Liability for Unpaid Claims and Claim Adjustment Expenses*

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	20X2	*20X1*
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

As a result of changes in estimates of insured events in prior years, the claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in 20X2 and 20X1, respectively) decreased by $171 million in 20X2 reflecting lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in 20X1 reflecting higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

4.135 The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph 4.132. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB ASC 450, FASB ASC 275, and SEC requirements.)

Note X. Environmental and Asbestos Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Chapter 5

The Investment Cycle

5.01 A property and liability insurance company functions as a conduit of funds. It collects funds from those desiring protection from financial loss and disburses funds to those who incur such losses. During the period between receipt of funds and the payment of losses, the property and liability insurance company invests the funds.

5.02 The assets of a property and liability insurance company consist mainly of investments in bonds, stocks, mortgage loans, and real estate.

Regulation

5.03 Because insurance companies have a public responsibility to be able to meet their obligations to policyholders, state insurance statutes and regulations prescribe standards and limitations on investment activities. Regulatory requirements and restrictions vary by state. Most states require insurance companies to invest a certain percent of reserves in specified classes of investments. Once the minimums are met, the company may invest in other kinds of investments. Most states, however, specify a maximum percentage of assets that may be invested in particular classes of investments. State regulations may also prescribe methods for reporting investments, set requirements regarding matters such as the location and safeguarding of assets, and set limitations on investing in futures, futures contracts, and options. For example, a regulatory authority may require some investments to be deposited with the state insurance department as a condition for writing business in that state. Insurance statutes and regulations vary by state, but the regulations of the state of domicile have precedence; however, substantial compliance provisions in certain states such as New York must also be followed. The auditor should obtain an understanding of the statutory requirements concerning investments of the company that could affect the company's intent to hold certain investments to maturity or recovery in fair value for impaired securities.

Investment Alternatives

5.04 Insurers plan their investment strategy to complement their insurance business. Funds are invested so that the income from investments plus maturities meets the ongoing cash flow needs of the company. This approach, one of matching assets and liabilities, requires a correct mix of long- and short-term investments and is generally referred to as *asset and liability management*.

Short-Term Investments

5.05 In addition to holding long-term investments consisting of bonds, stocks, real estate, and mortgages, insurance companies generally maintain short-term portfolios consisting of assets with maturities of less than one year to meet liquidity needs. Short-term investments of property and liability insurance companies typically consist of commercial paper, certificates of deposit, Treasury bills, and money market funds.

5.06 *Repurchase agreements.*[*] The use of repurchase agreements (repos) as a short-term investment has gained widespread acceptance. Repos and reverse repos (which include dollar repurchase and dollar reverse repurchase agreements) are contracts to sell and repurchase or to purchase and sell back the same or similar instrument (same issuer) within a specified time. In such transactions, the underlying securities may be received by the lender or a third-party custodian; they may also be designated or held by the borrower on behalf of the lender as "collateral." The maturity of the agreement is fixed by the contract and depends on the needs of the borrower and the willingness of the lender. For example, agreements may be structured on a day-by-day basis whereby the terms are negotiated daily.

5.07 The difference between the purchase price and the repurchase price, or sale price, plus accrued interest on the security represents investment income.

5.08 As stated in paragraph 5.06, and as defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, *dollar repurchase agreements* (also called *dollar rolls*) are agreements to sell and repurchase similar but not identical securities. The securities sold and repurchased are usually of the same issuer. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased have all of the following characteristics: (*a*) they are represented by different certificates, (*b*) they are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and (*c*) they generally have different principal amounts.

5.09 Dollar rolls are usually mortgage-backed securities (MBS), also referred to as *pass-through certificates* or *mortgage-participation certificates*. The most common types of dollar rolls are fixed-coupon and yield-maintenance agreements. In a *fixed-coupon agreement*, the securities repurchased have the same stated interest rate as, and maturities similar to, the securities sold and are generally priced to result in substantially the same yield. The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk. In a *yield-maintenance agreement*, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.[1] The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield-maintenance agreements may contain par cap provisions[2] that could significantly alter the economics of the transactions. In a *rollover* or *extension*, securities involved in repos are not delivered on the settlement date of the agreement and the contract may be rolled over or extended upon mutual

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[*] In March 2010, the Securities and Exchange Commission (SEC) sent an illustrative letter to certain public companies requesting information about repurchase agreements, securities lending transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets. The letter can be found on the SEC website at www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm.

[1] The price-spread relationship between securities with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

[2] A par cap provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed-coupon agreements do not contain par cap provisions.

agreement of the buyer-lender and seller-borrower. *Breakage* occurs when securities repurchased under repos commonly have a principal amount that differs from the principal amount of the security originally sold under the agreement. This is particularly common to dollar rolls. The difference occurs because the principal amounts of MBS generally differ as a result of the monthly amortization of principal balances of mortgages collateralizing the MBS. The amount of the breakage is a factor in determining whether substantially the same security is reacquired in the repo transaction, that is, whether good delivery (one in accordance with the terms of the agreement) has been met on repurchase of the MBS.

5.10 If the criteria in paragraph 9 of FASB ASC 860-10-40-5 are met, the transferor should account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee should account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets, which should be accounted for as sales, include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets. Under statutory accounting principles (SAP), paragraph 62 of Statement of Statutory Accounting Principles (SSAP) No. 91R, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, notes that if the transferor has surrendered control over transferred assets (as discussed in paragraph 5 of SSAP No. 91R) the transferor should account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee should account for the agreement as a purchase of financial assets and a forward resale commitment. Repurchase agreements that do not meet the control criteria (in paragraph 5 of SSAP No. 91R) should be treated as secured borrowings. See paragraphs 5.125–.126 for additional discussion of SSAP No. 91R.

5.11 Wash sales that previously were not recognized if the same financial asset was purchased soon before or after the sale should be accounted for as sales under FASB ASC 860, *Transfers and Servicing*. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets. See additional FASB ASC 860 guidance in paragraphs 5.78–.85.

5.12 *Securities lending.* Insurance companies occasionally loan their bonds and stocks to securities brokers or dealers for temporary purposes, generally to cover a broker's short-sale or fail transactions, the latter arising when securities are not delivered in proper form. In exchange for lending the securities, the company should receive cash (or other consideration) collateral from the broker in an amount equal to or exceeding the market values of the securities on that day; this collateral is immediately invested for the company's benefit. The market values of the securities on loan should be closely monitored because changes in excess of an agreed-upon range cause the release of the collateral or an increase in collateral. Securities lending has no effect on the valuation of securities for statutory accounting purposes, provided the amount of the collateral at least equals the required collateral as specified by the National Association of Insurance Commissioners (NAIC); however, if the collateral is less than required, the value of the securities would be written down under generally accepted accounting principles (GAAP).

5.13 In some securities lending transactions, the criteria in FASB ASC 860-10-40-5 are met and consideration other than beneficial interests in the transferred assets is received. Those transactions should be accounted for (*a*) by the transferor as a sale of the loaned securities for proceeds consisting of the cash collateral and a forward repurchase commitment and (*b*) by the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment.

5.14 However, some securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets. Those transactions should be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed and reclassified as set forth in FASB ASC 860-30-25-5(a), and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

5.15 The transferor of securities being loaned accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received should be recognized as the transferor's asset—as should investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being loaned accounts for those securities in the same way as it would account for cash received. FASB ASC 325-40 provides guidance on the recognition of interest income and impairment on purchased and retained beneficial interests in securitized financial assets.

Other Investment Alternatives

5.16 Insurance companies have been increasingly attracted to alternative investments as part of their overall investment management strategy. Among these alternatives are futures contracts, stock options, and similar financial instruments.

5.17 *Futures contracts.* Investments in futures contracts are gaining widespread acceptance as a means to hedge against market risk and help maintain a company's liquidity. Futures contracts are legal agreements between buyers or sellers and clearinghouses of futures exchanges; they represent commitments to buy or sell financial instruments at specified dates and prices.

5.18 *Options on equity securities.* In recent years, option writing by insurance companies has increased. State laws and regulations differ on the kinds of options, if any, that insurance companies are permitted to write, but some states permit insurance companies to write *covered-call options*. These are options for securities that insurance companies own and can deliver if the options are exercised by the option buyers. If an insurance company writes a covered-call option, it transfers to the option buyer the right to benefit from appreciation of the security underlying the option above the exercise price. Insurance companies usually write covered-call options because they consider the premium received for writing the options to be either (*a*) an economic hedge against a decline in the market price of the underlying security or (*b*) an increase in yield on the underlying security.

The Transaction Cycle

5.19 The investment cycle includes all functions relating to the purchase and sale of investments. The cycle encompasses investment income and gains and losses, as well as custody of investment and recordkeeping. The functions within this cycle may be segregated into separate subcycles for each major kind of investment (such as bonds, stocks, mortgages, and real estate) because of the different activities and considerations for each kind.

5.20 Except for differences caused primarily by the regulatory environment and investment objectives, the investment transaction cycle of property and liability insurance companies is generally similar to that found in other financial services industries.

Investment Evaluation

5.21 Most insurance companies have separate investment departments responsible for managing the companies' investable funds. The evaluation and subsequent purchase or sale of investments is based on the judgment of the company's investment and finance committees. Typically, the finance committee, which usually consists of top-level management, is responsible for all investment activity. An investment committee of the company's investment department is usually assigned the duty of evaluating investment transactions. In addition to such factors as market conditions, interest rates, and risk, the evaluation of investments includes consideration of the company's investment objectives, current and projected cash flows, and relevant state regulations. When regulatory compliance is in question, the transaction ordinarily should be referred to the legal department for evaluation.

Safekeeping

5.22 An insurance company's treasury department is usually responsible for the safekeeping of securities. Securities are either stored in a company vault to which access is limited to authorized personnel or are held in the custody of banks, securities depositories, or state departments of insurance. Coupon-bearing securities may be arranged in the vault by payment date to ensure that they are redeemed on a timely basis.

Recordkeeping

5.23 Investment-cycle journal entries are a basic input for the company's financial statements. Journal entries should be prepared accurately and promptly to ensure that the financial statements include all transactions in the proper period.

5.24 The accounting department prepares an investment purchases and sales journal, as well as interest-income and dividend-income lists. This information is recorded on a cash basis and is reconciled monthly with cash receipts and disbursements listed in the cashier's department. At the end of the period, journal entries are made to convert the information to the accrual basis by accruing for interest earned and dividends declared but not received and by recording investment transactions with trade dates before the end of the period but not settled until after that period ends.

5.25 IT applications are used to record most data relating to investment activity. Investment service reports and evaluation data (such as yield and income analyses, expected income, and market rate changes) may be produced by the computer and can provide management with an important source of information for the evaluation of investments. Management reports can be generated that indicate whether investments owned are in compliance with regulatory requirements. Key performance indicators utilized by management to monitor investing activities include: securities by type, maturity distributions, quality ratings, investment yields, realized and unrealized gains and losses, and nonperforming statistics.

FASB ASC 820 and 825 Fair Value Measurements and Disclosures and Financial Instruments†

5.26 As noted in FASB ASC 820-10-05-1, FASB ASC 820, *Fair Value Measurements and Disclosures,* defines fair value, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. The following paragraphs summarize FASB ASC 820 but are not intended as a substitute for reviewing FASB ASC 820 in its entirety.

Definition of Fair Value

5.27 FASB ASC 820-10-20 defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability either occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as "the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities."

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† The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have a joint project is to develop common fair value measurement guidance. To achieve this objective, FASB and the IASB have agreed to the following:

1. The project's objective is to ensure that fair value has the same meaning in U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRSs).
2. The project's goal is to make U.S. GAAP and IFRS guidance on fair value measurement the same, other than minor necessary differences in wording or style. FASB agreed to consider comments received on the IASB Exposure Draft *Fair Value Measurement* and to propose amendments to guidance on fair value measurement in U.S. GAAP to achieve that goal.
3. If perceptions of guidance on fair value measurement are different in U.S. GAAP and IFRSs, the boards will work together to address those perceptions.

On June 29, 2010, FASB issued proposed Accounting Standards Update (ASU) *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs,* with a comment period ending on September 7, 2010. On June 29, 2010, the IASB issued its Exposure Draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*, with a comment period ending on September 7, 2010. The exposure drafts are available on the FASB website.

5.28 FASB ASC 820-10-35-3 provides that the hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). Conceptually, entry prices and exit prices are different. However, FASB ASC 820-10-30-3 explains that, in many cases, at initial recognition a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity should consider facts specific to the transaction and the asset or liability.

5.29 Paragraphs 7–8 of FASB ASC 820-10-35 provide that the price should not be adjusted for transaction costs. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

Application to Assets

5.30 FASB ASC 820-10-35-10 provides that a fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

5.31 FASB ASC 820-10-35-10 provides that the highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. According to paragraphs 12–13 of FASB ASC 820-10-35, an asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

Application to Liabilities

5.32 According to FASB ASC 820-10-35-16, a fair value measurement assumes that both (1) the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled), and (2) the nonperformance risk relating to that liability is the same before and after its transfer. Paragraphs 17–18 of FASB ASC 820-10-35 provide that a fair value measurement of a liability should reflect its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

Valuation Techniques

5.33 Paragraphs 24–35 of FASB ASC 820-10-35 describe the valuation techniques that should be used to measure fair value. Valuation techniques consistent with the market approach, income approach, or cost approach should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

5.34 FASB ASC 820-10-35-24 states valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit) and the respective indications of fair value should be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results, example 3 (paragraphs 35–41) of FASB ASC 820-10-55 illustrates the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

5.35 As explained by paragraphs 25–26 of FASB ASC 820-10-35, valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*.

Present Value Techniques

5.36 Paragraphs 4–20 of FASB ASC 820-10-55 provide guidance on present value techniques. These paragraphs neither prescribe the use of one specific present value technique nor limit the use of present value techniques to the three techniques discussed therein. It states that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date: an estimate of future cash flows, expectations about possible variations in the amount or timing (or both) of the cash flows, the time value of money, the price for bearing the uncertainty inherent in the cash flows (risk premium), other case-specific factors that would be considered by market participants, and in the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk.

5.37 FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan, but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

5.38 FASB ASC 820-10-55-9 describes how present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value techniques uses a risk-free rate and risk-adjusted expected cash flows. Method 2 of the expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and expected cash flows. In the expected present value technique, the probability-weighted average of all possible cash flows is (referred to as the expected cash flows. The traditional present value technique and two methods of expected present value techniques are discussed more fully in paragraphs 4–20 of FASB ASC 820-10-55.

5.39 This guide includes guidance about measuring assets (promises to give and beneficial interests in trusts) and liabilities (spit-interest obligations) using traditional present value techniques. That guidance is not intended to suggest that the income approach is the only one of the three approaches that is appropriate in the circumstances, nor is it intended to suggest that the traditional present value technique described in the guide is preferred over other present value techniques.

The Fair Value Hierarchy

5.40 FASB ASC 820-10-35-51D emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, as stated by FASB ASC 820-10-35-9, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to in the statement as inputs). Paragraphs 37–62 of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

5.41 The fair value hierarchy in FASB ASC 820-10-35 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are described in the following list:

- Paragraphs 40–41 of FASB ASC 820-10-35 state that level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An *active market*, as defined by the FASB ASC glossary, is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 42–43 of FASB ASC 820-10-35. FASB ASC 820-10-44 provides guidance on how the quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor), but rather would be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held.

- Paragraphs 47–51 of FASB ASC 820-10-35 explain that level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. As discussed in FASB ASC 820-10-35-48, level 2 inputs include

- — quoted prices for similar assets or liabilities in active markets.
- — quoted prices for identical or similar assets or liabilities in markets that are not active.
- — inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates).
- — inputs that are derived principally from or corroborated by observable market data by correlation or other means.

- According to FASB ASC 820-10-35-51, an adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.
- As discussed in paragraphs 52–55 of FASB ASC 820-10-35, level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should be developed based on the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Assumptions about risk include the risk inherent in the inputs to the valuation technique. A measurement (for example, a mark-to-model measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability. The reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the entity's own data used to develop unobservable inputs should be adjusted if information is readily available without undue cost and effort that indicates that market participants would use different assumptions. FASB ASC 820-10-55-22 discusses level 3 inputs for particular assets and liabilities.

As explained in FASB ASC 820-10-35-37, in some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

5.42 As discussed in FASB ASC 820-10-35-38, the availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within level 2 or level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

5.43 As stated by FASB ASC 820-10-35-15, market participant assumptions should include assumptions about the effect of a restriction on the sale or use of an asset if market participants would consider the effect of the restriction in pricing the asset. Paragraphs 52–55 of FASB ASC 820-10-55 explain that restrictions that are an attribute of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value.

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)[‡]

5.44 "Pending Content" in paragraphs 58–62 of FASB ASC 820-10-35 contains guidance intended to improve financial reporting by permitting the use of a practical expedient, with appropriate disclosures, when measuring the fair value of an alternative investment that does not have a readily determinable fair value.

5.45 The practical expedient reduces complexity and improves consistency and comparability in the application of FASB ASC 820 while reducing the costs of applying FASB ASC 820. This guidance also improves transparency by requiring additional disclosures about investments within its scope to enable users of financial statements to understand the nature and risks of investments and whether the investments are probable of being sold at amounts different from net asset value per share.

5.46 According to "Pending Content" in FASB ASC 820-10-15-4, this guidance only applies to an investment that meets both of the following criteria:

[‡] In September 2009, FASB issued ASU No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. ASU No. 2009-12 provides guidance on using the net asset value per share provided by investees to estimate the fair value of an alternative investment. ASU No. 2009-12 provides amendments to FASB ASC 820, *Fair Value Measurements and Disclosures*, for the fair value measurement of investments in certain entities that calculate net asset value per share and requires disclosures by major category of investments about the attributes of those investments. Readers should consult ASU No. 2009-12 for further guidance.

ASU No. 2009-12 requires disclosures by major category of investment about the attributes of investments within the scope of ASU No. 2009-12. ASU No. 2009-12 is effective for interim and annual periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued. If an entity early adopts the measurement amendments of ASU No. 2009-12, the entity is permitted to defer the adoption of the disclosure provisions of FASB ASC 820-10-50-6A until periods ending after December 15, 2009.

This guidance is located in FASB ASC 820-10-15, FASB ASC 820-10-35, FASB ASC 820-10-50, and FASB ASC 820-10-55 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 820-10-65-6.

a. The investment does not have a readily determinable fair value.

b. The investment is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2P[3] or, if one or more of the attributes specified in FASB ASC 946-10-15-2 are not present, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

5.47 Examples of investments, to which this guidance applies, may include hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

5.48 "Pending Content" in FASB ASC 820-10-35-58 states that classification within the fair value hierarchy of a fair value measurement of an investment that is measured at net asset value per share requires judgment. This guidance provides considerations for determining the level within the fair value hierarchy that a fair value measurement of an investment at net asset value per share (or its equivalent) should be categorized.

5.49 "Pending Content" in paragraphs 59–62 of FASB ASC 820-10-35 create a practical expedient to measure the fair value of an investment on the basis of the net asset value per share of the investment (or its equivalent) determined as of the measurement date. Therefore, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the fair value of the investment if the practical expedient is used.

Fair Value Determination When the Volume or Level of Activity has Significantly Decreased

5.50 Paragraphs 51A–51H of FASB ASC 820-10-35 clarifies the application of FASB ASC 820 in determining fair value when the volume and level of activity for the asset or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, select paragraphs from paragraphs 59A–59M of FASB ASC 820-10-55 provide illustrations on the application of this guidance.

5.51 This guidance does not apply to quoted prices for an identical asset or liability in an active market (level 1 inputs). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

5.52 Consistent with FASB ASC 820-10-35-51D, when determining fair value when the volume and level of activity for the asset or liability has significantly decreased, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (not a forced liquidation or distressed sale)

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[3] FASB ASC 946-10-15-2 limits the scope of FASB ASC 946 to investment companies that have the following attributes:

a. Investment activity

b. Unit ownership

c. Pooling of funds

d. Reporting entity

between market participants at the measurement date under current market conditions in FASB ASC 820-10-35-51A lists a number of factors that may be evaluated to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability (or similar assets or liabilities) when compared with normal market activity. According to FASB ASC 820-10-35-51B, if, after evaluating the factors, the conclusion is reached that there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market conditions, transactions or quoted prices may not be determinative of fair value. Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB ASC 820-10. According to FASB ASC 820-10-35-51C, the objective is to determine the point within the range of fair value estimates that is most representative of fair value under the current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

5.53 FASB ASC 820-10-35-51D states that determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. The reporting entity's intention to hold the asset or liability is not relevant however, because fair value is a market-based measurement, not an entity-specific measurement.

5.54 According to FASB ASC 820-10-35-51E, an entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. Circumstances that may indicate that a transaction is not orderly and guidance that should be considered in the determination are found at paragraphs 51E–51F of FASB ASC 820-10-35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). In making the determination as to whether a transaction is orderly, an entity does not need to undertake all possible efforts, but should not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction. Refer to FASB ASC 820 for more information.

Disclosures[||, #]

5.55 Paragraphs 1–9 of FASB ASC 820-10-50 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities

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[||] FASB Staff Position FAS 157-4 amends the disclosure requirements of FASB ASC 820 to disclose in interim and annual periods the inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period. It also states that for equity and debt securities "major category" should be defined as major security type as described in "Pending Content" in FASB ASC 942-320-50-2 even if the equity securities or debt securities are not within the scope of FASB ASC 320. The revised disclosure requirements can be found as "Pending Content" at paragraphs 2 and 5 of FASB ASC 820-10-50.

[#] ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements*, will require additional disclosures related to FASB ASC 820-10. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the standard requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period.

Fair Value Option

5.56 FASB ASC 825, *Financial Instruments*, creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. An election is made on a instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements.

5.57 Most[4] financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts.

5.58 As explained by "Pending Content" in FASB ASC 825-10-15-5, specifically excluded from eligibility are (*a*) an investment in a subsidiary that the entity is required consolidate, (*b*) an interest in a variable interest entity that the entity is required to consolidate, (*c*) employer's and plan's obligations under postemployment, postretirement plans (including health care and life insurance benefits), and deferred compensation arrangements (or assets representing overfunded positions in those plans), (*d*) financial assets and liabilities recognized under leases (this does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease), (*e*) deposit liabilities of depository institutions, and (*f*) financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including temporary equity).

5.59 FASB ASC 825 also includes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Paragraphs 1–2 of FASB ASC 825-10-45 state that entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (*a*) report the aggregate carrying amount for both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. Although the fair value option does not require the organization to separately present interest income or interest expense in the income statement for interest-bearing financial assets or liabilities that are accounted for at fair value with all changes in fair value recognized in earnings, organizations may elect to separately disclose interest

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[4] An example of financial assets and financial liabilities which are not eligible include financial instruments with ongoing service commitments.

income or expense, and the related amortization, if such presentation is an identified industry practice.

Accounting Practices**

5.60 The specialized industry accounting principles for investments of insurance companies are specified in FASB ASC 944, *Financial Services—Insurance*, and FASB ASC 325, *Investments—Other*, provide guidance on the application of the interest method and other amortization matters. FASB ASC 310, *Receivables*, addresses the accounting by creditors for impairment of certain loans and accounting for loans that have evidence of credit quality deterioration and for which the purchaser does not expect to collect all contractual cash flows. FASB ASC 944 establishes reporting standards for insurance enterprises of realized gains and losses on investments. FASB ASC 320, *Investments—Debt and Equity Securities*, FASB ASC 815, *Derivatives and Hedging*, FASB ASC 820, and FASB ASC 825 establish standards of financial accounting and reporting by insurance companies for investments in equity securities that have readily determinable fair values and for all investments in debt securities. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*[5] (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in auditing investments in debt and equity securities and investments accounted for under FASB ASC 323, *Investments—Equity Method and Joint Ventures*. FASB ASC 320 requires that those investments to which it applies be classified in 3 categories at acquisition and that the appropriateness of the classification be reassessed at each reporting date. The categories established by FASB ASC 320 are as follows:

- Held-to-maturity securities[6,7]
- Trading securities
- Available-for-sale securities

** FASB and the IASB have a joint project on the accounting for financial instruments. The objective of this project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project will replace FASB's and the IASB's respective financial instruments standards with a common standard. The boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement.

On May 11, 2010, the IASB published an exposure draft for public comment with proposed changes to the fair value option (FVO) for financial liabilities. The proposals aim to ensure that changes in the credit risk of liabilities that an entity chooses to measure at fair value will not cause volatility in profit or loss. Therefore, the proposals will affect only those entities that choose to apply the FVO to their financial liabilities. The exposure draft *Fair Value Option for Financial Liabilities* is open for comment until July 16, 2010.

On May 26, 2010, FASB issued proposed ASU *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*, with comments due September 30, 2010. The Proposed ASU can be found on the FASB website at www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1175801893139.

[5] The companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

[6] FASB ASC 320-10-25-5(a) states that a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment.

[7] FASB ASC 320-10-25-5 requires a held-to-maturity debt security to be evaluated in accordance with FASB ASC 815-15 to determine whether it contains an embedded derivative that must be accounted for separately.

Held-to-Maturity Securities

5.61 Held-to-maturity securities are those debt securities for which the entity has the positive intent and ability to hold to maturity. For entities adopting FASB ASC 820 and electing the fair value option for these securities, the cumulative unrealized gains and losses at that date should be included in the cumulative-effect adjustment; these securities will be subsequently accounted for as trading securities. Otherwise, held-to-maturity securities should be measured at amortized cost. Amortized cost is the original cost of the security, reduced by amortization of premiums or increased by accretion of discounts. Amortization should be calculated using the interest method, which results in a constant effective yield.[8] Other methods of amortization may be used only if the results obtained are not materially different from those that would result from the interest method. The current-year amortization or accretion should be recorded as a charge or credit to investment income.

5.62 FASB ASC 320 recognizes that, although sales or transfers of these debt securities should be rare, there are certain changes in circumstances that may cause an entity to change its intent to hold a certain debt security to maturity. The subtopic lists changes in circumstances that might prompt an entity to transfer a debt security classified as held-to-maturity to another category without calling into question its intent to hold other debt securities to maturity in the future. As noted in FASB ASC 320-10-35-11, transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances identified in paragraphs 6(a)–(f) of FASB ASC 320-10-25. Payments of catastrophic claims by a property and liability insurer generally would not be considered such an event.

5.63 When debt securities are transferred from the held-to-maturity category to the trading category, the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings should be recognized in earnings immediately. When a debt security is transferred from the held-to-maturity category to the available-for-sale category, the unrealized holding gain or loss should be reported in other comprehensive income. When debt securities are transferred from the trading category to the held-to-maturity category, the unrealized holding gain or loss will have already been recognized in earnings and should not be reversed. When debt securities are transferred from the available-for-sale category to the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity, such as accumulated other comprehensive income, but should be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

5.64 As discussed in FASB ASC 320-10-50-5, for securities classified as held to maturity, all reporting entities should disclose all of the following by major security type as of each date for which a statement of financial position is presented. Maturity information may be combined in appropriate groupings. Securities not due at a single maturity date, such as MBS, may be disclosed

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[8] Note that under statutory accounting principles, one amortizes to the date that produces the lowest asset value (the "yield to worst" rule).

separately rather than allocated over several maturity groupings; if allocated, the basis for allocation also should be disclosed:

a. Aggregate fair value

b. Gross unrecognized holding gains

c. Gross unrecognized holding losses

d. Net carrying amount

e. Gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities

f. Information about the contractual maturities of those securities as of the date of the most recent statement of financial position presented (Maturity information may be combined in appropriate groupings. Securities not due at a single maturity date, such as mortgage-backed securities, may be disclosed separately rather than allocated over several maturity groupings; if allocated, the basis for allocation also shall be disclosed.)

Trading Securities

5.65 The FASB ASC glossary defines *trading securities* as securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. As discussed in FASB ASC 320-10-35-1, investments in debt securities that are classified as trading and equity securities that have readily determinable fair values that are classified as trading should be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for trading securities should be included in earnings.

5.66 FASB ASC 948-310-40-1 requires that after the securitization of a mortgage loan held for sale, any retained MBS should be classified in accordance with the provisions of FASB ASC 320. However, FASB ASC 948-310-35-3A states that a mortgage banking enterprise must classify as trading any retained MBS that it commits to sell before or during the securitization process.

5.67 For entities subject to depository and lending institution agency regulatory requirements, Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 105, *Application of Accounting Principles to Loan Commitments* (Codification of Staff Accounting Bulletins, Topic 5—*Miscellaneous Accounting*, Section DD—*Loan Commitments Accounted for as Derivative Instruments*), provides guidance on loan commitments accounted for as derivatives.[9]

5.68 Additionally, FASB ASC 310-10-50-25 states that certain loan products have contractual terms that expose entities to risk and uncertainties that fall into one or more categories, as discussed in FASB ASC 275-10-50-1. FASB ASC 825-10-50-1 requires disclosure of significant concentrations of credit risk arising from financial instruments.

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[9] The AICPA Practice Aid *Illustrative Disclosures on Derivative Loan Commitments* provides illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*.

5.69 If an entity accounts for mortgage servicing rights, FASB ASC 860-50-35 provides guidance for the disclosure of and accounting for servicing assets and servicing liabilities, including mortgage servicing rights. In general, the statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract if certain facts and circumstances exist. Additionally, all separately recognized servicing rights must be initially measured at fair value, if practicable. As discussed in FASB ASC 860-50-35-1, an entity should subsequently measure each class of separately recognized servicing assets and liabilities, using either of the following subsequent measurement methods: (*a*) amortization method—amortized servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date or (*b*) fair value measurement method—measure servicing assets or liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur. FASB ASC 860-50-35 also requires changed and additional disclosures for all separately recognized servicing rights.

5.70 FASB ASC 320 notes that given the nature of trading securities, transfers into or from the trading category should also be rare.[10] As discussed in FASB ASC 320-10-35-10, when such transfers occur, they should be accounted for as follows:

- When securities are transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will already have been recognized in earnings and should not be reversed.
- When securities are transferred into the trading category, the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings should be recognized in earnings immediately.

Available-for-Sale Securities

5.71 Available-for-sale securities are debt and equity securities that are not classified as either trading securities or held-to-maturity securities. Available-for-sale securities should be measured at fair value, with unrealized holding gains and losses excluded from earnings and reported as a net amount in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge should be recognized in earnings during the period of the hedge, pursuant to FASB ASC 815-25-35-1. Realized gains and losses on sales of securities classified as available-for-sale should continue to be reported in the income statement as a component of other income, on a pretax basis, in accordance with FASB ASC 944-325-45-3.

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[10] Based on guidance from a 2004 SEC speech to the AICPA National Conference on Current SEC and Public Company Accounting Oversight Board (PCAOB) Developments by John M. James, *Professional Accounting Fellow from the Office of the Chief Accountant*, it appears that transfers to or from the trading category are only appropriate in certain limited circumstances. Transfers appear to be appropriate only on the occurrence of an entity specific event that results in a significant change in circumstances. Such events would include new or changed regulation or statutory requirements, adoption of a new accounting policy or business combination or divestiture. It would not appear appropriate to transfer securities due to a change in intent.

5.72 Accounting for transfers of securities between the available-for-sale category and other categories is described throughout paragraphs 5.61 and 5.70.

Impairment of Securities

5.73 Paragraphs 18–33 of FASB ASC 320-10-35 provide guidance regarding determining whether a security is impaired and whether an impairment is other-than-temporary. Paragraphs 18–33 of FASB ASC 320-10-35 require that entities determine whether declines in the fair values of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other-than-temporary. (If a security has been the hedged item in a fair value hedge, the security's "amortized cost basis" should reflect the effect of the adjustments of its carrying amount made pursuant to FASB ASC 815-25-35-2. Paragraphs 20–29 of FASB ASC 320-10-35 discuss the steps to be taken in determining whether an investment is impaired. Paragraph 30 of FASB ASC 320-10-35 describe show to evaluate whether an impairment is other-than-temporary for both debt and equity securities. Paragraph 33 of FASB ASC 320-10-35 provides additional guidance for evaluating whether an impairment of a debt security is other than temporary.

5.74 *Equity securities.* FASB ASC 320-10-35-34 notes that for equity securities, if it is determined in step 2 that the impairment is other than temporary, then an impairment loss shall be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment shall not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new amortized cost basis of the investment and shall not be adjusted for subsequent recoveries in fair value.

5.75 *Debt securities.* Paragraphs 34A–34E of FASB ASC 320-10-35 discusses how to determine the amount of an other-than-temporary impairment recognized in earnings and other comprehensive income for debt securities (if it is determined that the impairment is other-than-temporary):

> If an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses, the entity shall consider the factors in paragraph 320-10-35-33F. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into both of the following:

a. The amount representing the credit loss.

b. The amount related to all other factors.

The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

The previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. However, the amortized cost basis shall be adjusted for accretion and amortization as prescribed in paragraph 320-10-35-35.

5.76 The following additional guidance discusses declines in the values of securities that are other-than-temporary. AU section 332 provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, investments in debt and equity securities, and investments accounted for under FASB ASC 323. Its companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementation. Additionally, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1),[11] establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements and FASB ASC 325-40 also provides guidance on recognition and measurement of other-than-temporary impairments. SEC SAB No. 59, *Accounting for Noncurrent Marketable Equity Securities* (Codification of Staff Accounting Bulletins, Topic 5—*Miscellaneous Accounting*, Section M—*Other Than Temporary Impairment of Certain Investments In Debt and Equity Securities*), sets forth the SEC staff's interpretation of the phrase *other-than-temporary*. The SEC's staff does not believe that *other-than-temporary* should be interpreted to mean permanent. Topic 5M states that if a decline in market value has occurred, management should determine whether a write-down should be recorded. In evaluating whether a write-down should be recorded, numerous factors should be considered, including the following:

- The length of time and extent to which the market value has been less than cost
- The financial condition and near-term prospects of the issuer, including any specific events that may influence its operations
- The intent and ability of the company to retain its investment for a period of time sufficient to allow for any recovery in market value

5.77 The SEC has issued Financial Reporting Release No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, which sets forth the commission's views concerning several disclosure matters, such as disclosures

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[11] For additional guidance, refer to Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 9328 par. .01–.04), and Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA, *Professional Standards*, vol. 1, AU sec. 9332 par. 01–.04), respectively. These interpretations were issued in 2005, subsequent to PCAOB adoption of AICPA standards as interim, on April 16, 2003.

for participation in high-yield financing, highly leveraged transactions, or noninvestment-grade loans and investments, that should be considered by registrants in preparing management's discussion and analysis.[12]

5.78 *Mortgage loans.* Mortgages are reported at amortized cost.[13] Premiums or discounts are generally amortized over the mortgage loan contract (or in some cases, a shorter period based on estimated prepayment patterns) in a manner that will result in a constant effective yield. Interest income and amortization amounts that are recognized as an adjustment of yield are included as components of interest income. Commitment fees should be amortized on a straight-line basis over the commitment period and recognized as service fee income. Amounts included in income on the expiration of the commitment period should also be recognized as service fee income. (FASB ASC 815-10-15-71 states that loan commitments relating to the origination of mortgage loans held for sale, as discussed in FASB ASC 948-310-25-3, should be accounted for as derivative instruments by the issuer of the loan commitment.) Loan origination fees should be recognized over the life of the related loan as an adjustment of yield using the interest method. The property and liability insurance company should recognize the impairment of a mortgage loan by creating a valuation allowance with a corresponding charge to bad debt expense or by adjusting an existing valuation allowance with a corresponding charge or credit to bad debt expense. FASB ASC 310 addresses the accounting by creditors for impairment of certain loans.

5.79 *Amortization of discounts on certain acquired loans.* The Accounting Standards Executive Committee issued AICPA Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined). For acquired loans or other debt securities within its scope, PB No. 6 includes guidance on (*a*) amortization of discounts that reflect impairment due to credit risk, (*b*) initial and subsequent recognition of principal and interest, and (*c*) assessing collectibility. PB No. 6's provisions on these issues are inconsistent with certain provisions of FASB ASC 310-30 and FASB ASC 320-10. FASB ASC 310-30-35 and FASB ASC 320-10-35 take precedence for loans and debt securities within their scope.

5.80 FASB ASC 310-30 applies to applicable loans acquired individually, in a portfolio, or in acquisition. FASB ASC 310-30 does not apply to any entity originated loans, or acquired loans without evidence of credit quality deterioration.[14] FASB ASC 310-30 should be applied to loans individually to meet the scope criteria and individual loans are not to be aggregated for determining whether they, as a group, are within the scope. Because the use of aggregation may result in different scope applicability, aggregation is only allowed for recognition, measurement and disclosure purposes.

5.81 FASB ASC 310-30 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment (purchase price) in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality.

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[12] Additionally, guidance for investment companies (and investment contracts) is provided in the AICPA Audit and Accounting Guide *Investment Companies*.

[13] FASB ASC 825-10-55 provides additional guidance on terms of loans products that may give rise to a concentration of credit risk.

[14] See FASB ASC 310-30-15-2 for the list of scope exceptions.

FASB ASC 310-30-35- 2 states that upon completion of a transfer of a loan, the investor should recognize the excess of all cash flows expected at acquisition over the investor's initial investment in the loan as interest income on a level-yield basis over the life of the loan.

5.82 Yield that may be accreted (accretable yield) is limited to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan.

5.83 FASB ASC 310-30-45-1 also requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable differences) not be recognized on the balance sheet or recognized as an adjustment of yield, loss accrual, or valuation allowance for credit risk. FASB ASC 310-30-45-1 prohibits investors from displaying accretable yield and nonaccretable difference on the balance sheet.

5.84 Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment.

5.85 FASB ASC 310-30-30- 1 prohibits "carrying over" or creating valuation allowances in the initial accounting of all loans acquired in a transfer that are within the standard's scope. FASB ASC 310-30-30-1 discusses that valuation allowances should reflect only those losses incurred by the investor after acquisition—that is, the present value of all cash flows expected at acquisition that ultimately are not to be received. For loans that are acquired by completion of a transfer, it is not appropriate, at acquisition, to establish a loss allowance. For loans acquired in a purchase business combination, the initial recognition of those loans should be the present value of amounts to be received. The loss accrual or valuation allowance recorded by the investor should reflect only losses incurred by the investor, rather than losses incurred by the transferor or the investor's estimate at acquisition of credit losses over the life of the loan. At the acquisition date, the amount of cash flows expected to be collected should be based on the index rate in effect at acquisition. Finally, FASB ASC 310-30 requires new disclosures, in addition to those already required by other accounting literature, including FASB ASC 450, *Contingencies*, and FASB ASC 320.

5.86 *Real estate investments.* In accordance with FASB ASC 944-360-30-2, real estate investments (except those held for sale) should be measured initially at cost. FASB ASC 944-360-35-5 states that depreciation and other related charges or credits should be charged or credited to investment income. FASB ASC 944-360-35-6 notes that reductions in the carrying amount of real estate investments resulting from the application of the impairment or disposal of long lived assets subsections of FASB ASC 360-10 should be included in realized gains and losses.

5.87 Additional authoritative accounting guidance is provided by FASB ASC 970-323 and FASB ASC 810-20. FASB ASC 360-20 provides guidance on accounting for real estate acquisition, development, or construction arrangements.

5.88 *Transfers and servicing of financial assets and extinguishments of liabilities.* FASB ASC 860-50 and FASB ASC 405-20 provide accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB ASC 860 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

5.89 As discussed in FASB ASC 860-10-40-4, a transfer of financial assets in which the transferor surrenders control over those assets should be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange.

5.90 As discussed in FASB ASC 860-10-40-5, the transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. *Isolation of transferred assets.* The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 7–14 of FASB ASC 860-10-40).

b. *Transferee's rights to pledge or exchange.* This condition is met if both of the following conditions are met:

 i. Each transferee (or, if the transferee is a qualifying special-purpose entity [see FASB ASC 860-40-15-3], each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received.

 ii. No condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (see paragraphs 15–21 of FASB ASC 860-10-40).

c. *Effective control.* The transferor does not maintain effective control over the transferred assets through either of the following:

 i. An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 23–27 of FASB ASC 860-10-40)

 ii. The ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 28–39 of FASB ASC 860-10-40).

5.91 As discussed in FASB ASC 860-10-35-3, upon completion of any transfer of financial assets, the transferor should do all of the following:

a. Apply the guidance in FASB ASC 860-50 for servicing assets and servicing liabilities that require recognition under the provisions of FASB ASC 860-50-25-1 (that is, measure initially at fair value if practicable)

b. Allocate the previous carrying amount between the assets sold, if any, and the interests that continue to be held by the transferor, if any, based on their relative fair values at the date of transfer (see related guidance in FASB ASC 860-20-25) *c.* Continue to carry in its statement of financial position any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and any undivided interests (see related guidance in FASB ASC 860-20-25).

5.92 For each class of separately recognized servicing assets and liabilities, FASB ASC 860-50 permits an entity to choose either of the following subsequent measurement methods: (*a*) the amortization of servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss or (*b*) the reporting of servicing assets or liabilities at fair value at each reporting date and reporting changes in fair value in earnings in the period in which the changes occur. FASB ASC 860-50 also requires changed and additional disclosures for all separately recognized servicing rights.

5.93 FASB ASC 860 requires that debtors reclassify financial assets pledged as collateral.

5.94 FASB ASC 405-20-40-1 notes that a debtor should derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
   i. Delivery of cash
   ii. Delivery of other financial assets
   iii. Delivery of goods or services
   iv. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

5.95 FASB ASC 860 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities.

Accounting for Derivative Instruments and Hedging Activities

5.96 FASB ASC 815 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. FASB ASC 815 requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those investments at fair value. If certain conditions are met, a derivative may be specifically designated as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (*b*) a hedge of the exposure to variable cash flows of a forecasted transaction, or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB ASC 815-10-50 also contains extensive disclosure requirements. Refer to the full text of the standards when considering accounting and reporting issues related to derivative instruments and hedging activities. The following is a list of insurance specific derivative issues that can be found within FASB ASC 815:

- 815-10-05 and 815-10-55—Definition of a Derivative: Synthetic Guaranteed Investment Contracts
- 944-20-05 and 944-815-25—Embedded Derivatives: Variable Annuity Products and Policyholder Ownership of the Assets
- 944-20-05 and 944-815-05—Embedded Derivatives: Identification of the Host Contract in a Nontraditional Variable Annuity Contract
- 815-15-55—Embedded Derivatives: Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options
- 815-15-55—Embedded Derivatives: Equity-Indexed Life Insurance Contracts
- 815-15-55—Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the end of the Accumulation Period
- 815-10-15 and 815-10-55—Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts
- 815-10-55—Embedded Derivatives: Dual-Trigger Financial Guarantee Contracts
- 815-10-55—Embedded Derivatives: Foreign Currency Elements of Insurance Contracts
- 815-10-55—Embedded Derivatives: Equity-Indexed Annuity Contracts with Embedded Derivatives
- 815-10-55—Embedded Derivatives: Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts
- 815-10-55—Modified Coinsurance Arrangements and Debt Instruments that Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor Under Those Instruments
- 815-15-25 and 815-15-55—Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets
- 815-15-55—Scope Exceptions: Exception Related to Physical Variables
- 944-815-55—Cash Flow Hedges: Hedging Voluntary Increases and Interest Credited on an Insurance Contract Liability
- 815-20-55—Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That are Not Based on a Benchmark Interest Rate

5.97 As discussed in FASB ASC 815-15-25-4, an entity that initially recognizes a hybrid financial instrument that under FASB ASC 815-15-25-1 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). A financial instrument should be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election. As discussed in FASB ASC 815-20-25-71, hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedge instrument in a FASB ASC 815 hedge.[15] Financial guarantees and investment contracts are allowed the fair value election as discussed in FASB ASC 815-15-25-4. As discussed in FASB ASC 815-15-25-6, the fair value election should not be applied to hybrid instruments described in FASB ASC 825-10-50-8.

5.98 Derivatives embedded in insurance contract hosts, such as equity-indexed annuities or nontraditional variable annuity contracts with minimum guarantees, would not be eligible for the fair value measurement election. FASB ASC 815-10-15-72 notes that interest-only strips and principal-only strips are not subject to the requirements of FASB ASC 815 if they have certain characteristics: FASB ASC 815-10-15-11 requires a holder of interests in securitized financial assets to evaluate interests in order to identify those interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation.

5.99 FASB ASC 815-15-15-9 notes that concentration of credit risk in the form of subordination of one financial instrument to another should not be considered an embedded derivative. However, this does not in any way negate FASB ASC 815 credit risk requirements, including the identification of credit risk that continues to represent credit risk that is not clearly and closely related to the host contracts such as with modified coinsurance arrangements and debt instruments.

5.100 FASB ASC 860-50 provides accounting for servicing of financial assets and requires that all separately recognized servicing rights be initially measured at fair value, if practicable.

5.101 For insurance companies issuing GAAP statements, FASB ASC 810, *Consolidation*, clarifies controlling financial interests defined for consolidation purposes. Insurance companies may participate in variable interest entities through investing in structured investments, such as asset-backed securities, synthetic asset-backed securities and catastrophe bonds, certain structured reinsurance transactions, joint ventures without substantive operations, financial guarantees, debt issuance vehicles, synthetic leases, collateralized bond obligation issuances, or limited partnerships.

Statutory Accounting Practices

5.102 *Investments in equity.* Under SAP, as noted in paragraph 7 of SSAP No. 30, *Investments in Common Stock (excluding Investments in common stock of subsidiary, controlled, or affiliated entities)*, unaffiliated common stock should be valued at fair value.

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[15] For those hybrid financial instruments measured at fair value under the practicability exception, FASB ASC 825-10-50-28 requires that the entity disclose specific information.

5.103 Preferred stock should be classified into six quality categories in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. As noted in SSAP No. 32, *Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*, paragraph 16, "Preferred stock shall be valued based on (*a*) the underlying characteristics of the security, (*b*) the quality rating of the security as defined in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* and assigned in the NAIC *Valuations of Securities* product, and (*c*) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity." Because property and liability insurance entities do not maintain an AVR, paragraph 16 continues

> for reporting entities that do not maintain an AVR, redeemable preferred stocks designated highest-quality and high-quality (NAIC designation RP1 and RP2, respectively) shall be reported at book value; perpetual preferred stocks designated highest-quality and high quality (NAIC designations P1 and P2, respectively) shall be reported at fair value; and redeemable preferred stocks and perpetual preferred stocks that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations RP3–RP6 and P3–P6, respectively) shall be reported at the lower of book value or fair value. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).[††]

5.104 Common and preferred stock acquisitions and dispositions shall be recorded on the trade date; private placement stock transactions shall be recorded on the funding date. A description and the amount of common or preferred stock that is restricted and the nature of the restriction are required to be disclosed. Both SSAP No. 30 and SSAP No. 32 reject FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Common and preferred stocks are also subject to both qualitative and quantitative limitations as defined by the state of domicile to qualify as admitted assets. Insurers are required to submit newly acquired unlisted securities, not subject to the filing exemption rule, to the NAIC Securities Valuation Office for valuation. Under the filing exemption rule, an insurer determines if a security is eligible for exemption based upon the nature of the rating for bonds and preferred stock, and upon market trading information for common stock.[‡‡]

5.105 Guidance for accounting for loan backed and structured securities, including collateralized mortgage obligations, is provided in SSAP No. 43R,

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[††] The National Association of Insurance Commissioners (NAIC) Financial Condition Committee had previously adopted a short term resolution for hybrid securities classification. At the Summer 2008 NAIC meeting, the NAIC decided not to adopt the short term "notching solution" but instead to adopt a 2007 report from the American Academy of Actuaries and to look for a long term solution to improve identification, classification, and accounting guidance for new structured investments. As of January 1, 2009, the notching solution has expired, and hybrid securities should be reported in Schedule D with a separate line number and the annual statement note disclosure for these holdings would be eliminated. A definition of hybrid securities was also added to the investment schedules instructions.

[‡‡] The NAIC is currently discussing modifications to the filing exemption rule. There is now a process that exempts certain securities rated by nationally recognized statistical rating organizations from filing with the NAIC Securities Valuation Office. Additionally, there are discussions in process to allow authorized companies to self-rate nonrated securities. The NAIC Valuation of Securities Task Force issued a proposed revision to the Securities Valuation Office manual addressing the methodology for self rating. Readers should be alert to new developments.

Loan-backed and Structured Settlements,[16] the NAIC's *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office. At purchase, loan-backed and structured securities are recorded at cost, including brokerage and related fees, but not at an amount in excess of fair value. Discount or premium is recorded for the difference between the purchase price and the principal amount. The discount or premium is amortized using the interest method and is recorded as an adjustment to investment income. The interest method results in the recognition of a constant rate of return on the investment equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments of book value. Paragraph 12 of SSAP No. 43R states that prepayments are a significant variable element in the cash flow of loan backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. As noted in SSAP No. 43R paragraphs 13–14

> Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). . . . Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17 through 19.

5.106 Paragraph 26 of SSAP No. 43R states

> The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* identifies which method loan-backed securities are subject to in determining NAIC designation. Securities within the scope of this statement will determine the NAIC designation as follows:
>
> *a.* For loan-backed securities subject to a single designation: The NAIC designation is the single designation assigned to a particular CUSIP in the Valuation of Securities product (either assigned by the NAIC Securities Valuation Office, or determined by the Filing Exempt process). This designation establishes the carrying value method as described in paragraph 25 and is reported in Schedule D. or
>
> *b.* For loan-backed securities subject to multiple designations:
>
> Securities subject to multiple designations shall use a two-step process for determining the carrying value method and final NAIC designation;
>
> i. Step 1: The current amortized cost of a loan-backed security is compared to the range of values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation. The carrying value method, either the amortized

[16] The NAIC Statutory Accounting Principles Working Group has developed an SSAP No. 43R, *Loan-backed and Structured Settlements*, Question and Answer Implementation Guide, which is available on the NAIC website.

cost or the lower of amortized cost or fair value, is then determined as described in paragraph 25 based upon the **initial** NAIC designation.

ii. Step 2: The final NAIC designation that shall be used for reporting is determined by comparing the carrying value of a security (based on paragraph 26 b.i.) to the range of values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for all statutory accounting and reporting purposes (including establishing the AVR charges), except for establishing the appropriate carrying value method in Step 1(paragraph 26 b.i.).

5.107 Interpretation No. 06-07, *Definition of the Phrase "Other Than Temporary,"* adopted with modification, certain aspects of FASB ASC 320. Interpretation No. 06-07 nullified Interpretation No. 02-7, *Definition of "Other Than Temporary Impairments,"* but adopted certain aspects of its consensus. Effective for fiscal year 2006, the NAIC codified SAP disclosure requirements based upon FASB ASC 320 into SSAP No. 26, *Bonds, excluding Loan-backed and Structured Securities*, SSAP No. 30, SSAP No. 32, and SSAP No. 43R, as amended by SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*.[||||]

5.108 Interpretation No. 06-07 includes a three step framework for other-than-temporary impairment analysis. In summary, steps 1 and 3 state that the determination of an investment impairment and valuation methodology, respectively, are governed by the relevant SSAP. Note that step 2 (in paragraph 5 of Interpretation No. 06-07), states that an interest-related impairment should be deemed other-than-temporary when an investor has the intent to sell an investment, at the reporting date, but before recovery of the cost of the investment. These interest-related declines in value, which now include changes in general credit spreads, are only recognized when the insurer has the intent to sell the security.

5.109 For impairments of loan backed and structured securities, paragraphs 28–37 of SSAP No. 43R state:

> The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value) is not a substitute for other-than-temporary impairment recognition (paragraphs 32–36). For securities reported at fair value where an other-than-temporary impairment has been determined to have occurred, the realized loss recognized from the other-than-temporary impairment shall first be applied towards the realization of any unrealized losses previously recorded as a result of fluctuations in the security's fair value due to the reporting requirements. After the recognition of the other-than-temporary impairment, the security shall continue to report unrealized gains and losses as a result of fluctuations in fair value.

[||||] Statement of Statutory Accounting Principles (SSAP) No. 43, *Loan-Backed and Structured Securities*, is also amended by SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP 43-Loan-Backed and Structured Securities*, effective for quarterly and annual reporting periods ending on or after September 30, 2009, with early adoption permitted.

If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss (including any cumulative-effect adjustments recognized in accordance with paragraphs 56 through 58 of SSAP No. 43R).

If an entity intends to sell the loan-backed or structured security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability[17] to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a noninterest related decline[18] exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loaned-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cash flows expected to be collected. In determining whether a noninterest related decline exists, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed or structured security, discounted at the security's effective interest rate.

a. For securities accounted for under paragraphs 12 through 16—the effective interest rate of the loan-backed or structured security is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net

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[17] This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of SSAP No. 43R (amortized cost).

[18] A noninterest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.

deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).[19]

b. For securities accounted for under paragraphs 17 through 19—the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.

c. For securities accounted for under paragraphs 20 through 24—the reporting entity shall apply the guidance in paragraph 22.b.

When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized.)

When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate in accordance with paragraph 32. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized for the noninterest related decline. Hence, unrealized losses could continue to be reflected for these securities due to the reporting requirements.)

For reporting entities required to maintain an AVR or IMR, the accounting for the other-than-temporary impairment shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Noninterest related other-than-temporary impairment losses shall be recorded through the AVR. If the reporting entity wrote the security down to fair value due to the intent to sell or does not have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the noninterest related portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the IMR.

For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 34 and 35 of this Statement, the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of

[19] See footnote 1.

the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore, the prospective adjustment method shall be used for periods subsequent to loss recognition.

5.110 SSAP No. 99 paragraphs 8–11 discuss accounting for other-than-temporary impairments for preferred stock:

Impairment of Redeemable Preferred Stock

An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the security in effect at the time of acquisition. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below carrying value (i.e. amortized cost). If it is determined that a decline in fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7, *Asset Valuation Reserve and Interest Maintenance Reserve*.

In periods subsequent to the recognition of an other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporary impaired security as if the security had been purchased at the measurement date of the other-than-temporary impairment, and in accordance with paragraph 18 or paragraph 20 of SSAP No. 32, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Impairment of Perpetual Preferred Stock

If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7, *Asset Valuation Reserve and Interest Maintenance Reserve*.

In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporary impaired security as if the security had been purchased at the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21 of SSAP No. 32, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

5.111 For equity securities not listed in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, or listed with no value, it is the responsibility of management to determine a fair value that can be substantiated to the appropriate NAIC subcommittee or regulatory agency based on analytical or pricing mechanisms. The property and casualty entity is required to submit sufficient information on these securities to the NAIC Securities Valuation Office for a determination of fair value.

5.112 SSAP No. 97, *Investments in Subsidiary, Controlled, or Affiliated Entities, A Replacement of SSAP No. 88*, requires that investments in subsidiary, controlled, or affiliated (SCA) entities be reported using either a market valuation approach or equity methods. There are specific requirements to use the market valuation approach, including the requirement to record at a discount to market (the requirements can be found in SSAP No. 97 paragraph 8a). Under the equity method, investments in insurance SCA entities should be recorded based on audited statutory equity of the respective entity's financial statements. Investments in noninsurance SCA entities that are engaged in specific transactions or activities [as defined in SSAP No. 97 paragraph 8b(ii)] and have 20 percent or more of the SCA's revenue generated from the reporting entity and its affiliates, are valued based upon the underlying equity of the respective entity's audited GAAP financial statements adjusted to a statutory basis of accounting (as explained in paragraph 9 of SSAP No. 97). Investments in noninsurance SCA entities that do not qualify under paragraph 8b(ii) of SSAP No. 97 should be recorded based on the audited U.S. GAAP equity of the investee; investments in foreign insurance SCA entities should be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 and adjusted for reserves of the foreign insurance SCA with respect to business it assumes directly and indirectly from a U.S. insurer using the SAP promulgated by the NAIC in the manual. Note, however, that the admissibility of assets may be limited when a qualified opinion is provided. Interpretation No. 03-03 of the Emerging Accounting Issues Working Group, *Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee When a Qualified Opinion is Provided*, sets forth the adjustment criteria.

5.113 As defined in SSAP No. 97 paragraph 13d, "if financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period." Investments in U.S. insurance SCA entities accounted for under the equity method (recorded based on the underlying audited statutory equity as noted in paragraph 8b(i) in SSAP No. 97), should record the investments on at least a quarterly basis, and base the investment value on the most recent quarterly information available for the SCA. Under the equity method (as described in paragraphs 8b(i)–8b(iv) of SSAP No. 97), the share of undistributed earnings and losses of an investee is included in unrealized gains and losses of the reporting entity. Some other changes in the investee surplus are also recorded as a component of unrealized capital gains and losses on investment. Dividends or distributions received are recognized in income when declared with a concurrent adjustment to the investment account and unrealized capital gains and loses. The carrying amount of the investment is reduced to the extent dividends declared are in excess of undistributed accumulated earnings.

5.114 Under the U.S. GAAP equity method, the amount to be recorded should be defined as the initial investment in the investee at cost (excluding any investments in an investee's preferred stock). As discussed in paragraph 12 of SSAP No. 97, the carrying amount of the investment should be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. Paragraph 14 of SSAP No. 97 states that once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method without approval of the domiciliary commissioner. Paragraph 31e of SSAP No. 97 requires that the reporting entity disclosure a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses for SCA entities for which it elected, or was required to change its valuation method. The entity should also disclose whether commissioner approval was obtained.

5.115 *Investments in debt.* Under statutory accounting practices, qualifying debt securities are subject to the valuation standards of the NAIC, as described in the NAIC's *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. Debt securities should be carried at amortized cost, except for those with an NAIC designation of 3 to 6, which should be reported at the lower of amortized cost or fair value. More specifically, the amortization or accretion under SAP is calculated by the "yield to worst" interest method; one amortizes to the date that produces the lowest asset value. An acquisition or disposal of a debt security should be recorded on the trade date, except for private placement bonds, which should be recorded on the funding date.

5.116 As noted in paragraphs 5–6 of SSAP No.99, which amends SSAP No. 26,

> An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the time of acquisition. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below carrying value. If it is determined that a decline in fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of

fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7. Credit related other-than-temporary impairment losses shall be recorded through AVR; interest related other-than-temporary impairments shall be recorded through IMR.

In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporary impaired security as if the security had been purchased at the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

5.117 As noted in SSAP No. 26 paragraph 10, "Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual." Interest income determined to be uncollectible should be written off through the summary of operations, and an evaluation made to determine nonadmitted amounts. Under SAP, a collectibility test similar to GAAP is used to determine whether an impairment of investment income exists, as explained in SSAP No. 34, *Investment Income Due and Accrued*. If the interest is deemed uncollectible, the amount should be written off and charged against investment income in the current period. Interest not related to mortgage loans, which is deemed collectible, is considered nonadmitted if 90 days or more past due.

5.118 Requirements for carrying debt securities as admitted assets vary at the discretion of the states. A debt security must be classified as a nonadmitted asset if it fails a qualitative or quantitative limitation test or is otherwise unauthorized by the applicable state code.

5.119 Paragraph 15 of SSAP No. 32, states that redeemable preferred stock should be classified into 6 quality categories (NAIC designations RP1–RP6) in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. As noted in SSAP No. 32 paragraph 16, "Preferred stock shall be valued based on (*a*) the underlying characteristics of the security, (*b*) the quality rating of the security as defined in the NAIC *Purposes and Procedures of the Securities Valuation Office* (Purposes and Procedures of the SVO) and assigned in the NAIC *Valuations of Securities* product, and (*c*) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity." For reporting entities that maintain an AVR, redeemable preferred stocks designated highest quality, high quality, and medium quality (NAIC designations RP1– RP3) should be reported at book value; redeemable preferred stocks that are designated low quality, lowest quality and in or near default (NAIC designations RP4–RP6) should be reported at the lower of book value or fair value. For reporting entities that do not maintain an AVR, redeemable preferred stocks designated RP1 and RP2 should be reported at book value; redeemable preferred stocks that are designated RP3–RP6 should be reported at the lower of book value or fair value. Paragraph 17 of SSAP No. 32 states that for reporting entities required to maintain an AVR, the accounting for unrealized gains and losses should be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, unrealized gains and losses should be recorded as a direct credit or charge to unassigned funds (surplus).

5.120 As further noted in SSAP No. 32 paragraph 18, for reporting entities that do not maintain an AVR, "Highest-quality or high-quality redeemable preferred stock, (NAIC designations 1–2) which have characteristics of debt securities, should be valued at cost or amortized cost. All other redeemable preferred stocks (with NAIC designations 3 to 6) should be reported at the lower of cost, amortized cost, or fair value." See SSAP No. 32 and paragraph 5.83 of this guide for impairment guidance.

5.121 *Derivative instruments and hedging activities.* The NAIC has incorporated certain concepts of FASB ASC 815 in SSAP No. 86, *Accounting for Derivative Instruments and Hedging Activities, Income Generation and Replication (Synthetic Asset Transactions)*. SSAP No. 86 superseded SSAP No. 31, *Derivative Instruments*, and was effective for derivative transactions entered into or modified on or after January 1, 2003. Alternatively, an insurer was able to choose to apply this statement to all derivatives to which the insurer was a party as of January 1, 2003. In either case, the insurer had to disclose the transition approach that was being or is still being used.

5.122 Under SSAP No. 86, *derivatives* are defined as swaps, options, futures, caps, floors, and collars. SSAP No. 86 provides definitions for these terms. The more significant differences between SSAP No. 86 and FASB ASC 815 include the following:

- Embedded derivatives should not be accounted for separately from the host contract as a derivative instrument. (Under SSAP No. 86, the definition of a derivative continues to be based on its legal form or contractual rights and obligations, in contrast with FASB ASC 815 where the definition is based on instrument characteristics. Consequently, certain contracts that may not meet the definition of a derivative may contain embedded derivative instruments.)
- Reporting entities should not separately account for the effectiveness and ineffectiveness of hedging derivatives. (A derivative instrument is either classified as an effective hedge or an ineffective hedge). Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective.
- Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge are accounted for using hedge accounting. A reporting entity utilizes fair value accounting for an ineffective hedge.
- Changes in the fair value of a derivative that does not meet the hedging criteria should be recorded as unrealized gains and losses.

5.123 SSAP No. 86 generally adopted FASB ASC 815 framework for fair value and cash flow hedges. It also adopts FASB ASC 815 provisions for foreign currency hedges. It allows derivatives to be designated as hedging exposure to changes in fair value, variability in expected cash flows, or foreign currency exposures. Hedge accounting is permitted for derivatives to hedge a portfolio of similar assets or similar liabilities but macro hedging (hedging of an entire portfolio with dissimilar risks) does not qualify for hedge accounting. Firm commitments and forecasted transactions are eligible for designation as hedged transactions. Forecasted transactions must meet additional specific criteria to be designated in a cash flow hedge.

5.124 To qualify for hedge accounting, a fair value, cash flow, and foreign currency hedge must be highly effective. Highly effective is specifically defined within SSAP No. 86 as where the change in the derivative hedging instruments is within 80 percent to 125 percent of the change in the hedged item. The concept within FASB ASC 815 of identifying and separately accounting for effective and ineffective portions of a single hedge was rejected; therefore, the ineffective portion of an effective hedge need not be separately recognized in income. An entity either has an effective hedge and follows hedge accounting or an ineffective hedge and uses fair value accounting (recognition in unrealized gains and losses).

5.125 Under SSAP No. 86, derivatives used in hedging activities should be accounted for in a manner consistent with the item hedged (that is, if the item being hedged is accounted for at amortized cost, the hedging derivative is also accounted for at amortized cost). SSAP No. 86 paragraph 15 states

> Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. For derivatives that do not qualify for hedge accounting, nonhedging derivatives are accounted for at fair value. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

5.126 Under SSAP No. 86, for a gain or loss upon termination, paragraph 17 states, "Upon termination of a derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be recognized in income in a manner that is consistent with the hedged item." Additionally, SSAP No. 86 exhibit C guidance is provided for redesignation of a derivative from a currently effective hedging relationship. The redesignation of an item carried at amortized cost to another effective hedging relationship with an item carried at amortized cost, should continue to be recorded at amortized cost with no gain or loss on the derivative recognized.

5.127 *Loans.* Under SAP, the amount recorded as the initial investment in a loan is the principal of the loan, net of deferred loan origination and commitment fees. If purchased, the loan is recorded at the amount paid, net of premium or discount. Some states stipulate maximum loan values that limit the extent to which outstanding principal balances can be reported as admitted assets, and most states have restrictions that apply to the size of the individual loan in relation to the appraised value of the mortgaged property either at the origination date, the current valuation date, or both.

5.128 Procedures for amortizing discounts and premiums on mortgage loans are included in SSAP No. 37, *Mortgage Loans*. Loan commitment fees are deferred, and should be amortized over the life of the loan if the commitment is exercised. If the commitment is not exercised, the fee should be recognized in income on the commitment expiration date. Nonrefundable loan origination fees that represent points, should be deferred and amortized over the life of the loan. Nonrefundable loan origination fees, other than points, should not be recorded until received in cash. All costs related to loan origination, acquisition, and commitments should be charged to expense as incurred.

5.129 As noted in SSAP No. 37 paragraph 16,

> A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. . . . A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing valuation allowance with a corresponding charge or credit to unrealized gain or loss. . . . Mortgage loans for which foreclosure is probable shall be considered permanently impaired.

Nonrecoverable costs should be expensed in the period incurred. For mortgages that are in default, voluntarily conveyance, or foreclosure, the carrying value is adjusted for unpaid interest and additional expenses, such as legal fees to the extent they are expected to be recovered from the ultimate disposition of the property. Under SAP, troubled debt restructurings should be accounted for according to the type of the restructuring (transfer of assets in full settlement, grant of equity interest in full settlement, modification of terms, or combination of types.) As noted in SSAP No. 36, *Troubled Debt Restructuring*, "Generally, troubled debt restructuring involving the transfer of assets or the grant of an equity interest shall be accounted for at the fair value of the assets transferred or the equity interest granted." Restructurings involving only modifications of terms are accounted for at fair value. If the restructuring is for a collateral dependent loan, the asset is written down to the fair value of the underlying collateral. If the loan is not collateral dependent, the fair value should be determined in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, if applicable, or at the present value of expected future cash flows (see SSAP No. 36 paragraphs 10–12). A mortgage loan in which the title to the asset is being obtained should be reclassified to real estate at the beginning of the redemption period unless it is probable that the loan will be redeemed.

5.130 Interest income on mortgage loans is recorded as earned, and contingent interest may be recorded as earned or as received. As noted in SSAP No. 37 paragraph 14

> If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue

to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued.

5.131 SSAP No. 83, *Disclosure to Appendix A-001*, provides accounting and reporting guidance for mezzanine real estate loans (MRELs). Loans that meet the definition of a MREL are admitted assets and follow the accounting and reporting guidelines for mortgage loans contained within SSAP No. 37.

5.132 *Real estate.* Under SAP, SSAP No. 40, *Real Estate Investments*, paragraph 4, "Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of the related encumbrances: *a*) Properties occupied by the company; *b*) Properties held for the production of income; and *c*) Properties held for sale." Properties occupied by the company and properties held for the production of income should be reported at depreciated cost. Properties held for sale should be reported at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. As noted in SSAP No. 40 paragraph 11, "The current fair value of real estate shall be determined on a property by property basis . . . and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale . . . If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon all relevant data about the market . . ." Appraisals are required to be no more than five years old, and a current appraisal should be obtained if there has been a significant decline in fair value. For real estate used in an entity's operations, the insurance entity is required to charge itself imputed rent, which is recorded as investment income and an operating expense in the annual statement.

5.133 SSAP No. 90, *Accounting for the Impairment or Disposal of Real Estate Investments*, incorporates FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, as amended by SSAP No. 95, *Exchange of Nonmonetary Assest, A Replacement of SSAP No. 28—Nonmonetary Transactions*, concepts of the recognition and measurement of an impairment loss with certain SAP modifications. For example, under SSAP No. 90 estimates of future cash flows used to test the reasonability of a long-lived asset should only use their best estimate in testing.

5.134 For properties held for sale, SSAP No. 90 paragraph 4 states, "an impairment loss shall be recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The carrying amount . . . is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. . . . An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. . ." See the glossary to the SSAP for a discussion of fair value. The impairment loss should be recorded in the summary of operations as a realized loss.

5.135 Paragraph 17 of SSAP No. 90 requires properties occupied by the company and properties held for the production of income should be carried at depreciated cost less encumbrances. Properties held for sale are carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. Real estate properties classified as held for sale are disallowed from recognizing increases in fair value less cost to sell until the asset is sold. The concept of grouping the asset for impairment purposes is rejected for SAP.

5.136 *Additional equity investments.* Under SAP, except for companies within the scope of SSAP No. 93, *Accounting for Low Income Housing Tax Credit Property Investments*, SSAP No. 48, *Joint Ventures, Partnerships and Limited Liability Companies*, provides that joint ventures, partnerships, and limited liability corporations, except those with a minority interest (less than 10 percent), should be accounted for in accordance with the equity method as defined under SSAP No. 97. Refer to discussion of SSAP No. 97 in paragraphs 5.87–.89 of this guide. Investments in joint ventures, partnerships and limited liability entities in which the entity has a minor ownership interest or lacks control as stipulated in paragraphs 9–10 of SSAP No. 48, should be accounted for based on the audited U.S. GAAP equity. As discussed in paragraph 8 of SSAP No. 48, if audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest or lacks control may be recorded based on either the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements, or the International Financial Reporting Standards (IFRSs) basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both quarterly and annually, with IFRSs as issued by the International Accounting Standards Board, or the underlying audited U.S. tax basis equity. These kinds of investments should be reported in Other Invested Assets in the financial statements. A nonsubstantive change to SSAP No. 48 allows the grand fathering of investments made prior to January 1, 2001, for GAAP audits. If the reporting entity (together with all other investors) does not have sufficient voting power (pursuant to the joint venture, partnership or limited liability agreement) to force the preparation of audited GAAP financial statements, the reporting entity may then value its investment based on unaudited GAAP or audited tax basis financial statements. Note that the admissibility of assets may be limited when a qualified opinion is provided. Interpretation No. 03-03 of the Accounting Issues Working Group, *Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee When a Qualified Opinion is Provided*, sets forth the adjustment criteria.

5.137 Effective for reporting periods beginning on or after January 1, 2006, SSAP No. 93 establishes statutory accounting practices for investments in federal and certain state sponsored low income housing tax credit properties. SSAP No. 93 adopts FASB ASC 323-740 with modifications. SSAP No. 93 requires the amortized cost method of EITF Issue No. 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects," with a modification to include tax benefits during the holding period. SSAP No. 93 provides that investments in federal and certain state sponsored low income housing tax credit properties having certain characteristics, as described in paragraph 1 of SSAP No. 93 be initially recorded at cost and carried at amortized cost unless considered impaired. Paragraphs 12–15 of SSAP No. 93 discuss the impairment of low income housing tax credit properties.

5.138 *Asset transfer servicing and liability extinguishment.* Under SAP, SSAP No. 91R adopts portions of FASB ASC 860 with the following modifications as noted in paragraph 94 of the SSAP:

a. Servicing rights assets are to be nonadmitted;

b. Sales treatment is not permitted for transactions where recourse provisions or removal-of-accounts provisions exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special purpose entities should not be consolidated in a reporting entity's statutory financial statements;

d. Leases should be accounted for in accordance with SSAP No. 22, *Leases*;

e. Reporting entities required to maintain an IMR should account for realized and unrealized capital gains and losses in accordance with SSAP No. 7;

f. The concepts of revolving-period securitizations, banker's acceptances and risk participation in banker's acceptances are not applicable for statutory accounting purposes; and

g. This statement does not adopt the accounting for collateral as outlined in FASB ASC 860.

5.139 SSAP No. 91R sets forth specific collateral requirements for securities lending, repurchase, and reverse repurchase transactions. The collateral requirement varies based upon the type of transaction (securities lending, repurchase, reverse repurchase) or denomination of the collateral. SSAP No. 91R adopts FASB ASC 860 for accounting for wash sales to permit sales recognition, but also requires expanded disclosures (see SSAP No. 91R paragraphs 89–92 for listing of information to be disclosed).

Special Risk Considerations

5.140 A key element to an effective audit is an understanding of the entity and its environment. As discussed in chapter 2, "Audit Considerations," the auditor's understanding of the entity and its environment consists of an understanding of industry, regulatory, and other external factors; the nature of the entity; objectives and strategies and the related business risks that may result in a material misstatement of the financial statements; measurement and review of the entity's financial performance; and internal control, which includes the selection and application of accounting policies (see the following section for further discussion). Such understanding allows the auditor to assess the risk of material misstatement and facilitate the design of effective and efficient audit tests. Applicable standards pertaining to the discussion of internal control include, but are not limited to, AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, and AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), among others. For further discussion, see chapter 2 of this guide.

5.141 Property and liability insurance companies may incur increased underwriting losses as a consequence of their willingness to adopt a less restrictive underwriting philosophy to obtain more premium dollars to invest. This could be done as long as investment income exceeds expected underwriting losses by a sufficient margin, sometimes known as *cash flow underwriting*. However, when losses continue to increase and interest rates decline, it may be necessary to revise this strategy. Although underwriters may react by raising prices and tightening underwriting standards, greater investment performance may be necessary to offset increased underwriting losses. In addition to understanding this operating environment, the auditor may consider the following risk factors relating to the investment cycle that may affect carrying values, pricing, and other-than-temporary impairments:

- Investment concentration, by issuer, industry, or other and management monitoring thereof
- Investment liquidity, including investments with terms and maturities not matched with claims obligations
- Investment valuation, such as improper or inadequate valuation methods, documentation, or impairments that are other-than-temporary, and significant amounts of investments that are not readily marketable, and downgrading of securities by rating agencies
- Investment yield trends (that is, the indicated ability to manage the investment portfolio at maximum yields commensurate with prudent risk considerations)
- Investment policy, such as emphasis on speculative or high-risk investments and defining investment strategy
- Investment restrictions (that is, degree of compliance with regulatory or self-imposed restrictions)
- Investment repurchase agreements, such as (*a*) the risk that the seller-borrower may not be able to complete the transaction and repurchase the security—credit risk, or (*b*) the risk that the collateral is not secure—particularly if it remains with the seller-borrower (guidance on such matters is provided by the AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions*)
- Significant changes in interest rates

Chapter 6

Reinsurance

6.01 Insurance entities bring together people and entities subject to insurable hazards and collect from them premium amounts expected in the aggregate to be sufficient to pay all losses sustained by the insureds during the policy periods. From the insurer's perspective, the number of insureds, and how diverse they are affect whether or not the law of averages will operate. Frequently, however, an insurance entity may be offered or may accept, for business reasons, insurance of a class or amount that does not permit the law of averages to operate or that could result in claims the insurer does not have the financial capacity to absorb. Such risks are spread among other insurance entities through reinsurance, which is the indemnification by one insurer of all or part of a risk originally undertaken by another insurer.

6.02 In addition to using reinsurance to spread the risk of its insurance contracts, an insurer may use reinsurance contracts to finance the growth of its business in terms of premiums written and loss reserve. In this regard, an insurance entity's gross capacity (ability to write business) is limited by law or regulation based on the amount of its statutory surplus. The greater the ratio of premiums written or liabilities to such surplus, the less likely it is that the surplus will be sufficient to withstand adverse claim experience on business written. Through reinsurance contracts, an insurer can increase its ability to underwrite risks, thus effectively using reinsurance to facilitate the growth of its business.

6.03 The following are major reasons insurance entities enter into reinsurance contracts:

- To help balance their risks and capital
- To reduce their exposure on particular risks or classes of risks
- To protect against accumulations of losses arising out of catastrophes
- To reduce total liabilities to a level appropriate to their capital
- To provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted
- To help stabilize operating results
- To obtain assistance with new products and lines of insurance
- To limit liabilities of captive insurance entities, created for the purpose of supplying insurance to noninsurance entities, to a level considered acceptable by the parent entities

For similar reasons, reinsurers also may transfer a portion of their assumed risks to other insurance and reinsurance entities, a practice known as *retrocession*.

Types of Reinsurance

6.04 Reinsurance transactions are between insurance entities, the ceding entity remains primarily liable to the policyholder. In addition, the ceding entity bears the risks that the reinsurer may be unable to meet its obligations for the risks assumed under the reinsurance agreement. The policyholder is generally not aware of any indemnity reinsurance transactions that may occur and continues to hold the original contract.

6.05 *Assumption reinsurance* agreements are legal replacements of one insurer by another and thereby extinguish the ceding enterprise's liability to the policyholder.

6.06 *Fronting*. The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines *fronting* as a reinsurance arrangement in which the ceding entity issues a policy and reinsures all or substantially all of the insurance risk with the assuming entity.

6.07 Such arrangements may be illegal if the intent is to circumvent regulatory requirements. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), addresses the auditor's responsibility for detection of illegal acts. As with other indemnity reinsurance agreements, the fronting entity remains primarily liable to the policyholder.

6.08 In the United States there are basically three kinds of reinsurance entities: (*a*) *professional reinsurers*, which engage almost exclusively in reinsurance, although they are usually permitted by their charters and licenses to operate as primary insurance entities; (*b*) *reinsurance departments of primary insurance entities*, which function as units of primary insurers and engage in reinsurance; and (*c*) groups or syndicates of insurers referred to as *reinsurance pools or associations*, which may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk coverage or with general access to the reinsurance market for traditional lines of business. In addition, reinsurance intermediaries, including brokers, agents, managing general agents, and similar entities, facilitate reinsurance by bringing together ceding entities and reinsurers. Reinsurance intermediaries may underwrite, design, and negotiate the terms of reinsurance. They usually place reinsurance, accumulate and report transactions, distribute premiums, and collect and settle claims.

6.09 In addition to providing for a basic ceding commission, intended to reimburse the ceding insurer for the cost of underwriting the business, reinsurance contracts may also provide for contingent commissions or retrospectively rated premiums, which are intended to allow the ceding insurer to share in the profits or losses realized by the assuming reinsurer on the business subject to the contract. Reinsurance contracts additionally may provide for sliding scale commissions, or commission adjustments under a formula that allows increasing commissions as losses decrease and vice versa, subject to maximum and minimum limits. Contract provisions such as these may affect the risk transfer characteristics that determine how reinsurance contracts are accounted for.

Kinds of Reinsurance Contracts

6.10 Flexibility is one of the characteristics of the reinsurance business. Reinsurance contracts are usually negotiated individually and in practice no two contracts are exactly alike. Contracts are occasionally encountered that cannot be readily classified. However, the principal kinds of reinsurance are pro rata reinsurance and excess reinsurance.

6.11 *Pro rata reinsurance.* Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and the reinsurer of premiums and losses on a risk, class of risks, or particular portion of the insurer's business.

In consideration of a predetermined portion of the insurer's premium or premiums, the reinsurer agrees to pay a similar portion of claims and claim-adjustment expenses incurred on the business reinsured. The reinsurer's participation in the claims is set without regard to the actual frequency and severity of claims. Pro rata reinsurance can be affected by means of quota share or surplus share reinsurance.

6.12 *Quota share reinsurance.* Quota share reinsurance is a kind of pro rata reinsurance in which the ceding entity cedes a proportional part (a percentage) of risks to the reinsurer, and in turn will recover from the reinsurer the same percentage of all losses on those risks. For example, under a 50 percent quota-share treaty, the reinsurer receives 50 percent of the insurer's premiums, less ceding commissions, and is obligated to pay 50 percent of each claim as well as the claim-adjustment expense incurred by the insurer. Such reinsurance is frequently used for new lines or by new entities; for example, an entity just entering the casualty field may arrange for quota share reinsurance only for its casualty business.

6.13 *Surplus share reinsurance.* Surplus share reinsurance is insurance that reinsures on a pro rata basis only those risks on which the coverage exceeds a stated amount. Under a surplus treaty, an insurer might reinsure what it considers to be surplus exposure under each large dwelling policy that it writes. For example, the insurer might reinsure the amount of each dwelling policy above $25,000; the insurer would reinsure $15,000 on a dwelling policy for $40,000. Premiums and losses are shared by the reinsurer and the insurer on a pro-rata basis in proportion to the amount of risk insured or reinsured by each. The reinsurer would not participate at all in any losses incurred on policies with limits of $25,000 or less.

6.14 *Excess reinsurance.* Under excess reinsurance, the insurer limits its liability to all or a particular portion of the amount in excess of a predetermined deductible or retention. Thus, the reinsurer's portion of the loss depends on the size of the loss. The relationship between the premium and claims of the insurer and the reinsurer is not proportional. Excess reinsurance takes three basic forms: per risk basis, per occurrence basis, and aggregate basis.

6.15 *Excess of loss per risk reinsurance.* Excess of loss per risk reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on each risk covered under the reinsurance, such as all fire policies written. The reinsurer reimburses the insured for the portion of any claim in excess of the insurer's retention, subject to the limit stated in the reinsurance agreement.

6.16 *Excess of loss per occurrence reinsurance.* Excess of loss per occurrence reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on all losses arising from a single occurrence. The reinsurer pays claims in excess of the limits. One purpose of obtaining per occurrence excess reinsurance is to protect an entity from the accumulation of losses arising from earthquakes, tornadoes, or similar occurrences. Such reinsurance is also referred to as *catastrophe reinsurance*.

6.17 *Aggregate excess of loss reinsurance.* Aggregate excess of loss reinsurance requires the insurer to pay all claims during a specified period up to a predetermined limit for the period on all its business or any definable portion of the claim. This is usually expressed as a loss ratio (for example, reinsurance against losses that would cause an entity's loss ratio to exceed 75 percent). Such reinsurance is also referred to as *stop loss reinsurance*.

Bases of Reinsurance Transactions

6.18 Reinsurance is transacted either on a facultative or a treaty basis. Under *facultative reinsurance*, each risk or portion of a risk is reinsured individually, and the assuming entity has the option to accept or reject each risk. Risks are separately underwritten by the assuming entity in much the same manner as if a direct policy were being issued. The assuming entity therefore has all of the policy information necessary to maintain all of the accounting records, including gross premiums and reinsurance premiums, term of the policy, reinsurance commissions, and individual claims data. Because the assuming entity must specifically obligate itself before assuming the risk, the entity is aware of all of the risks assumed at any point. The assuming entity maintains complete records about all facultative business assumed and, therefore, has information needed to account for premiums written and receivable, commissions incurred and payable, and losses and expenses incurred and payable.

6.19 Under *treaty-basis reinsurance*, any agreed portion of business written is automatically reinsured, thereby eliminating the need for the assuming entity to accept or reject each risk. Because of the time lag in reporting by the ceding entity, the assuming entity is likely to be unaware of some of the risks it has assumed at a particular point. The reports received by the assuming entity from the ceding entity may be complete *bordereaus* (or listings) of pertinent information on each risk or summaries of risks.

6.20 If the ceding entity reports only summarized information, the assuming entity may not have complete information relating to reinsurance activities. For example, without knowing the reinsurance premiums by policy term, the assuming entity cannot directly calculate its unearned premium reserve; but generally should use amounts reported by the ceding entity. The assuming entity, which has no direct relationship with the insured, generally depends on the ceding entity to report the reinsured portion of reported claims and, in some quota-share-treaty accounts, the estimated liability for incurred but not reported (IBNR) claims. Despite the lack of detailed information, the assuming entity is responsible for properly accounting for the transaction.

6.21 Reinsurance may be transacted and serviced directly between the ceding and assuming entities or through reinsurance intermediaries, brokers, agents, or managing general agents. Reporting of information to the assuming entity is negotiated as part of a reinsurance transaction involving an intermediary or broker.

Accounting Practices*

6.22 FASB ASC 944, *Financial Services—Insurance*, specifies the accounting by insurance enterprises for the reinsurance (ceding) of insurance contracts,

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* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards (IFRSs) to entites that issue insurance contracts and is now complete. The issuance of IFRS No. 4, *Insurance Contracts*, along with IFRS No. 4 Basis for Conclusions and IFRS No. 4 Implementation Guidance, brought to a close phase I of the international insurance project. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued an invitation to comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper*, Preliminary Views on Insurance Contracts. That

(continued)

and FASB ASC 340-30 provides guidance for accounting for reinsurance contracts that do not transfer insurance risk.

6.23 *Conditions for qualifying for reinsurance accounting.* In general, FASB ASC 944 requires a determination of whether or not a reinsurance agreement, despite its form, qualifies for reinsurance accounting. To qualify, a reinsurance contract should indemnify the ceding enterprise from loss or liability relating to insurance risk. FASB ASC 944-20-15-40 addresses determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk. Paragraphs 41, 46, 49, 51, and 53 of FASB ASC 944-20-15 address criteria for short-term contracts to be accounted for as reinsurance. Paragraphs 59–61 of FASB ASC 944-20-15 address criteria for long-duration contracts to be accounted for as reinsurance.

6.24 FASB ASC 944 discusses accounting for multiple-year retrospectively rated contracts by ceding and assuming enterprises. Examples of these contracts may include transactions referred to as *funded catastrophe covers*.

Reporting Assets and Liabilities

6.25 *Assumption reinsurance.* These reinsurance agreements are legal replacements of one insurer by another and thereby extinguish the ceding enterprise's liability to the policyholder and should be accounted for by removing the related assets and liabilities from the financial statements of the ceding entity. Assumption reinsurance transactions may result in an immediate recognition of a gain or loss. This is sometimes referred to as a *novation*.

6.26 *Other reinsurance agreements.* Reinsurance agreements for which the ceding entity remains primarily liable to the contract holders would not result in the removal of the related assets and liabilities from the ceding entities' records. For these agreements, the ceding entity should report as assets, estimated reinsurance receivables and any prepaid reinsurance premiums arising from those agreements. Amounts receivable from and payable to an assuming entity should be offset only when a right of offset exists, as defined in FASB ASC 210-20.

6.27 Reinsurance receivables and prepaid reinsurance premiums should be recognized in a manner consistent with the related liabilities (estimates for claims incurred but not IBNR and future policy benefits) relating to the underlying insurance contracts. Assumptions used in estimating reinsurance receivables should be consistent with those assumptions used in estimating the related liabilities. As in all reinsurance contracts, the ceding entity should evaluate the financial soundness and the collectibility of reinsurance receivables, to make a determination that the reinsurer has the ability to honor its commitment under the contract.

(footnote continued)

invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project. The boards are planning to release an exposure draft in the third quarter 2010. Readers should remain alert to any final pronouncements and refer to the revised FASB IASB Memorandum of Understanding.

6.28 The amounts of premiums ceded and recoveries under reinsurance agreements may be reported in the income statements as a separate line item, noted parenthetically on the face of the income statement, or disclosed in the footnotes to the financial statements.

Reporting Revenues and Costs

6.29 Paragraph 20 of FASB ASC 944-605-25 and paragraphs 8–9 and 11–13 of FASB ASC 944-605-35 provide guidance on recognition of revenues and costs for reinsurance of short-duration contracts. Paragraphs 14–15 of FASB ASC 944-605-35 provide guidance on recognition of revenues and costs for reinsurance of long-duration contracts.

Reinsurance Agreements Not Qualifying for Reinsurance Accounting Under FASB ASC 944

6.30 FASB ASC 944 does not specifically address accounting for reinsurance agreements that do not meet the conditions for reinsurance accounting, other than to incorporate the following specific provisions:

a. As discussed in FASB ASC 720-20-25-1, to the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer should be accounted for as a deposit by the ceding enterprise. A net credit resulting from the contract should be reported as a liability by the ceding enterprise. A net charge resulting from the contract should be reported as an asset by the reinsurer.

b. As discussed in FASB ASC 944-30-35-64, proceeds from reinsurance transactions that represent recovery of acquisition costs should reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized.[1] As noted in FASB ASC 944-405-25-1, if the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability should be accrued for estimated excess future servicing costs under the reinsurance contract. Also as discussed in FASB ASC 944-30-25-13, the net cost to the assuming enterprise should be accounted for as an acquisition cost.

6.31 FASB ASC 340-30 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. The transfer of insurance risk requires transferring both timing risk and underwriting risk. FASB ASC 340-30 applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to as *deposit accounting*. FASB ASC 340-30 neither addresses when deposit accounting should be applied, nor provides criteria to make that determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements. FASB ASC

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[1] FASB *Accounting Standards Codification* (ASC) 944-30 addresses recognition of acquisition costs.

944-20-15-36 provides guidance on when deposit accounting should be applied to insurance and reinsurance contracts.

6.32 FASB ASC 340-30-30-1 requires that at inception, a deposit asset or liability be recognized for insurance or reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. FASB ASC 340-30-45-1 notes that deposit asset and liabilities should be reported on a gross basis, unless the right of setoff exists as defined in FASB ASC 210-20. The accounting by the insured and insurer are symmetrical, except as noted in paragraphs 6–7 of FASB ASC 340-30-35.

6.33 Paragraphs 3–6 of FASB 340-30-25, paragraphs 1–7 of FASB ASC 340-30-30, and paragraphs 2–5 of FASB ASC 340-30-45 provide guidance about the measurement of the deposit asset or liability at subsequent reporting dates. The subsequent measurement of the deposits is based upon whether the insurance and reinsurance contract (*a*) transfers only significant timing risk, (*b*) transfers only significant underwriting risk, (*c*) transfers neither significant timing nor underwriting risk, or (*d*) has indeterminate risk.

6.34 Paragraphs 1–2 of FASB ASC 340-30-50 require the following disclosures:

a. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

b. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

   i. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses.

   ii. Any adjustments of amounts initially recognized for expected recoveries. (The individual components of the adjustment [interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries] should be disclosed separately.)

   iii. The amortization expense attributable to the expiration of coverage provided under the contract.

6.35 *Experience-rated refunds.* Some reinsurance agreements provide for experience-rated refunds, which allows the ceding entity to participate in the profits of the reinsured business. In general, experience refunds are determined by the assuming entity by deducting from premiums assumed claims or losses incurred and a predetermined reinsurance profit (expense and profit charge). Most experience-rated reinsurance agreements will have stated terms for calculation formulas and other factors to be included.

Disclosures

6.36 FASB ASC 944-605-50-1 and FASB ASC 944-825-55-1 prescribe information that should be disclosed regarding reinsurance activities. Paragraphs 1–2 of FASB ASC 340-30-50 require disclosures about contracts that do not transfer insurance risk.

Statutory Accounting Practices

6.37 Under statutory accounting practices, as under generally accepted accounting principles, the essential ingredient of a reinsurance contract is the indemnification of risk. A number of states regulate reinsurance arrangements by disallowing the recognition of increased surplus resulting from nonrisk-shifting arrangements. In general, the accounting treatment by ceding entities for reinsurance transactions is opposite from that of transactions that arise from writing direct business, and the amounts of the reinsurance transactions are netted against the direct amounts for financial statement presentation (for example, the premium accounts are netted against the direct amounts for premiums related to insurance ceded). The assuming entity's accounting for reinsurance normally parallels the original accounting for direct business. Refer to Statement of Statutory Accounting Principle (SSAP) No. 62, *Property and Casualty Reinsurance*, for additional guidance on property and casualty reinsurance. Additional information can be found in SSAP No. 75, *Reinsurance Deposit Accounting—An amendment of SSAP No. 62, Property and Casualty Reinsurance*.

6.38 The terms *unauthorized reinsurer* and *nonadmitted reinsurer* refer to a reinsurer not authorized or licensed to do business in the state in which the ceding entity is domiciled. Licensed entities can write direct business in the state; if licensed, an entity is also authorized to assume reinsurance in that state. A nonlicensed entity can assume reinsurance if the state authorizes it to do so, and it is then considered to be an authorized reinsurer. In statutory financial statements, the ceding entity cannot obtain surplus credit for unearned premiums ceded to and losses recoverable from an unauthorized reinsurer unless collateralized by assets held, a letter of credit, or other forms of qualifying collateral. A ceding entity must establish a liability for unauthorized reinsurance in an amount equal to the excess of the reserve credits taken over the funds held or letter of credit for the business ceded. Note that the National Association of Insurance Commissioners is discussing potential changes that could reduce the collateral requirements for unauthorized reinsurers.

Special Risk Considerations

6.39 Reinsurance contracts can be complex documents. A ceding entity does not discharge its obligations to the insureds through reinsurance but only obtains the right to reimbursement from the assuming entity. Therefore, the ceding entity faces the risk that the assuming entity may not have the financial capacity or stability to meet its obligations when they are due. An absence of an adequate reinsurance program may expose an insurance entity (the ceding entity) to substantial risks in relation to the entity's financial position, particularly if the entity's risks are concentrated geographically or by kind of risk. Also, a lack of sufficient experience to manage and underwrite assumed reinsurance may expose the assuming entity to substantial risks in relation to the entity's financial position. Therefore, the auditor should be aware that reinsurance programs may indicate (but do not necessarily confirm) the existence of increased risk of material misstatement.

6.40 The assumption of reinsurance generally requires special consideration of the accuracy and reliability of the data received from the ceding entity, either directly or through a reinsurance intermediary. The extent of the detail in the information provided to the assuming entity by the ceding entity or the reinsurance intermediary can vary significantly in

- timeliness of the information submitted.
- detail of information relating to policies, claims, unearned premiums, and loss reserves.
- annual statement line-of-business classification.
- foreign currency translation information on business assumed from entities domiciled in foreign countries (alien entities).

6.41 Information on IBNR claims and bulk reserves also may be reported by ceding entities under pro rata reinsurance arrangements. Generally, no IBNR is reported on nonproportional—that is, excess reinsurance—arrangements. Based on the quality and comprehensiveness of the information received from the ceding entity, the information provided may or may not be used by the assuming entity.

Internal Control of the Ceding Entity

6.42 The auditor of a ceding entity generally should obtain an understanding of the entity's procedures for (*a*) evaluating the financial responsibility and stability of the assuming entity, whether the assuming entity is domiciled in the United States or in a foreign country, and (*b*) providing reasonable assurance about the accuracy and reliability of information reported to the assuming entity and amounts due to or from the assuming entity. The ceding entity's control activities to evaluate the financial responsibility and stability of the assuming entity may include

- obtaining and analyzing recent financial information of the assuming entity, such as
  - — financial statements and, if audited, the independent auditor's report.
  - — financial reports filed with the Securities and Exchange Commission (SEC) (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - — financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the entity's invested assets.
- obtaining and reviewing available sources of information relating to the assuming entity, such as
  - — insurance industry reporting and rating services.
  - — insurance department examination reports.

 - loss reserve certifications filed with regulatory authorities.
 - letters relating to the design and operation of controls filed with regulatory authorities.
 - Insurance Regulatory Information System and risk-based capital results filed with regulatory authorities.

- inquiring about the assuming entity's retrocessional practices and experience.
- inquiring about the general business reputation of the assuming entity and the background of its owners and management.
- ascertaining whether the assuming entity is authorized to transact reinsurance within the ceding entity's state of domicile or, if not, whether letters of credit or other means of security are provided.
- considering the need for and evaluating the adequacy of collateral from the assuming entity on collateralized reinsurance contracts.

6.43 The ceding entity's control activities relating to the accuracy and reliability of information reported to the assuming entity and amounts due to or from the assuming entity are generally similar in nature to other control activities for the direct recording of direct insurance transactions. (Those control activities are described in appendix B.)

Control Environment

6.44 The control environment as related to reinsurance transactions of a property and liability insurance entity represents the collective effect of various factors on the effectiveness of specific control activities of the entity. When assessing the risks of material misstatement, the auditor may consider inherent risk factors related to reinsurance assumed and ceded, including factors relating to management, product characteristics, underwriting approach, marketing strategies, financial objectives, and the economic and regulatory environment. Such factors might include the following:

- The property and liability insurance entity uses complex reinsurance transactions at or near the end of the period to achieve financial performance goals or improve its surplus position.
- The property and liability insurance entity is involved in a significant amount of international reinsurance, or reinsurers are in jurisdictions with foreign exchange controls.
- There are no executed contractual agreements between the ceding entity and the reinsurer.
- Reinsurance coverage is inadequate (it does not meet the business need or does not reflect management's intended reinsurance program).
- The ceding entity's reinsurers are in financial difficulty.
- Reinsurance has become unavailable at the property and liability insurance entity's desired retention levels and costs.
- There are significant or unexpected changes in the entity's reinsurance programs.

- The reinsurance agreement does not transfer adequate economic risk where this was the intention of the parties.
- Risk assumed under treaty arrangements is excessive.
- Financial information received is inadequate, or not received on a timely basis.
- Regulations may not permit the treatment of certain reinsurance agreements as reinsurance.
- Significant reinsurance agreements involve wholly owned subsidiaries or other related parties.

Control Activities

6.45 Control activities are those policies and procedures that help ensure that management directives are carried out and that necessary actions are taken to address risks to achieve the entity's objectives. In addition to control activities, discussed in paragraph 6.42, relating to the evaluation of the control activities of the reinsurer, the following are examples of typical controls relating to reinsurance transactions:

- *Proper authorization of transactions and activities.* Written guidelines for reinsurance transactions are in place assigning appropriate responsibility for approval.
- *Segregation of duties.* Reinsurance transactions, claims processing, premium collection, key information systems functions, and general accounting activities are appropriately segregated, and independent reviews are conducted of the work performed.
- *Design of adequate control over documents and records.* Procedures are in place to ensure that fictitious or duplicate reinsurance transactions are not included in the records and to prevent or detect the omission of valid transactions.
- *Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access; and adequate safeguards exist over access to any collateral from the assuming entity that may be held by the ceding entity.
- *Independent checks on performance and proper valuation of recorded amounts.* Recorded insurance transactions are subject to independent testing or other quality control checks; reinsurance ceded transactions are periodically confirmed directly with the reinsurer; reviews are performed to determine that reinsurance transactions are valid and supported by appropriate documentation as required by the reinsurance agreement; and independent evaluations are performed on the adequacy of any collateral held from assuming entities on reinsurance agreements.

Considerations for Audits Performed in Accordance with PCAOB Standards

For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]). Also refer to paragraph 54 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) for a discussion on the extent of tests of controls (paragraph .97 of AU section 319).

Information and Communications

6.46 Paragraph .81 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.

6.47 The transaction flow of accounting records for reinsurance transactions usually encompasses all functions relating to underwriting, premium collection, commission processing, and claims payments.

Internal Control of the Assuming Entity

6.48 A significant component of an assuming entity's internal control that is related to assumed reinsurance is the assessment of the accuracy and reliability of data received from the ceding entities. Principal control activities of the assuming entity may include

- maintaining underwriting files with information relating to the business reasons for entering the reinsurance contracts and anticipated results of the contracts. The underwriting files may include
  - — historical loss ratios and combined ratios of the ceding entities.
  - — anticipated loss ratios under the contracts.
  - — indications of the frequency and content of reports for the ceding entities.
  - — prior business experience with the ceding entities.
  - — the assuming entity's experience on similar risks.
  - — information regarding pricing and ceding commissions.
- monitoring the actual results reported by the ceding entities and investigating the reasons for and the effects of significant deviations from anticipated results.
- visiting the ceding entities to review and to evaluate their underwriting, claims processing, loss reserving, and loss-reserve-development-monitoring procedures.

- obtaining the report of the ceding entities' independent accountants on controls (relating to ceding reinsurance) placed in operation (and tests of operating effectiveness). See AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).

Considerations for Audits Performed in Accordance with PCAOB Standards

Refer to paragraphs B10–B16 of appendix B, "Special Topics," in PCAOB Auditing Standard No. 5 regarding the use of service organizations.[2]

6.49 Additional control activities of the assuming entity may include

- obtaining and analyzing recent financial information of the ceding entities, such as
  - — financial statements and, if audited, the independent auditor's report.
  - — financial reports filed with the SEC (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - — financial statements filed with insurance regulatory authorities, with particular attention to loss reserve development.
- obtaining and reviewing available sources of information on the ceding entities, such as
  - — insurance industry reporting and rating services.
  - — insurance department examination reports.
  - — loss reserve certifications filed with regulatory authorities.
  - — letters relating to the design and operation of controls filed with regulatory authorities.
- inquiries about the general business reputation of the ceding entities and the background of their owners and managements.

Auditing Procedures for the Ceding Entity

6.50 Several important reinsurance issues are discussed in the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce's report *Failed Promises: Insurance Company Insolvencies* (issued February 1990).[3]

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[2] The Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* includes illustrative control objectives as well as interpretations that address responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers. Additionally, the Public Company Accounting Oversight Board (PCAOB) staff has issued a series of nonauthoritative Q&As on various topics.

[3] This paragraph also applies to the assuming company's independent auditor (refer to paragraph 6.54) and to the auditor of reinsurance intermediaries (refer to paragraph 6.39).

6.51 The ceding entity's independent auditor should obtain an understanding of the ceding entity's ability to honor its commitments under the reinsurance contract. Chapters 2, "Audit Considerations," and 4, "The Loss Reserving and Claims Cycle," of this guide discuss how the auditor assesses control risk. If the auditor intends to rely on the prescribed procedures, the auditor should perform tests of the ceding entity's procedures to obtain reasonable assurance that they are in use and operating as planned.

6.52 The absence of adequate procedures by the ceding entity to determine the assuming entity's ability to honor its contractual commitments, or the failure to apply adequately designed procedures as planned, may constitute a significant deficiency or material weakness in the ceding entity's internal control. AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit*, discusses the auditor's responsibility for communication of a significant deficiency in internal control to the audit committee. Based on his or her assessment of the risks of material misstatement, the auditor may consider performing substantive procedures sufficient to evaluate the collectability of amounts reported in the financial statements as recoverable from the assuming entity. The auditor's tests may include certain of the procedures specified above but they are not necessarily limited to those procedures. Additionally, regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.[4]

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> In an audit of financial statements only, conducted in accordance with PCAOB standards, former AU section 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), has been superseded as described in AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). For an integrated audit, former AU section 325 has been superseded by paragraphs 78–84 of PCAOB Auditing Standard No. 5.

6.53 To obtain reasonable assurance whether reinsurance contracts are appropriately accounted for, the independent auditor of the ceding entity might consider performing procedures for selected contracts, selected transactions, and related balances, including

- reading the reinsurance contract and related correspondence to
  - — obtain an understanding of the business objective of the reinsurance contract.
  - — determine whether the contract indemnifies the ceding entity against loss or liability, and meets the conditions for reinsurance accounting or whether it should be accounted for under deposit accounting, as defined in FASB ASC 340-30.

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[4] For audits performed in accordance with PCAOB standards, the sentence reads "Regardless of the assessed level of control risk *or the assessed risk of material misstatement in connection with the audit of the financial statements*, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures."

- tracing entries arising from selected reinsurance contracts to the appropriate records.
- tracing the selected transactions to supporting documents and testing the related receivables and payables.
- obtaining written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Auditing Procedures for the Assuming Entity

6.54 An assuming entity's independent auditor may obtain an understanding of the assuming entity's procedures for assessing the accuracy and reliability of data received from the ceding entities. If the auditor intends to assess control risk as being less than maximum, he or she should evaluate the suitability of the assuming entity's procedures for his or her purposes and test the procedures to obtain evidence that they are in use and operating as prescribed.[5]

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Additionally, when performing an integrated audit in accordance with PCAOB standards, paragraphs .65 and .83 of AU section 319 state that if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Paragraph .83 of AU section 319 also states that accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion.

6.55 The absence of adequate procedures by the assuming entity to provide assurance regarding the accuracy and reliability of data received from the ceding entity, or not applying adequately designed procedures that are in use and operating as prescribed, may constitute a significant deficiency or material weakness in the assuming entity's internal control. Based on his or her assessment of the risks of material misstatement, the auditor should perform substantive procedures sufficient to obtain assurance regarding the accuracy and reliability of the data received from the ceding entities. The auditor's substantive procedures may include, but would not necessarily be limited to, one or more of the following:

- Performing certain procedures described as control activities in paragraph 6.49.
- Meeting and reviewing the work of the ceding entities' independent auditors (see AU section 543, *Part of Audit Performed by Other Independent Auditors* [AICPA, *Professional Standards*, vol. 1]). Additionally for integrated audits, refer to paragraphs C8–C11 of appendix C, "Special Reporting Situations," of PCAOB Auditing Standard No. 5, which provides direction with respect to opinions based, in part, on the report of another auditor.
- Performing auditing procedures at the ceding entities or requesting their independent auditors to perform agreed-upon procedures.

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[5] Refer to "Auditing Procedures for the Ceding Entity" in paragraphs 6.50–.53.

- Obtaining reports from the ceding entities' independent auditors on the ceding entities' internal control relating to ceded reinsurance (see AU section 324).[6] Additionally, when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B10–B16 of appendix B, "Special Topics," in PCAOB Auditing Standard No. 5 regarding the use of service organizations.

6.56 The auditor's inability to perform the procedures considered necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient appropriate audit evidence, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify the opinion or disclaim an opinion (see AU section 508, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1]). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the audit report.

6.57 To determine whether reinsurance contracts are appropriately accounted for, the independent auditor of the assuming entity might perform procedures for selected contracts, selected transactions, and related balances, including

- reading the reinsurance contract and related correspondence to
  - — obtain an understanding of the business objective of the reinsurance contract.
  - — determine whether the contract is properly accounted for as reinsurance or deposit.
- tracing entries arising from selected reinsurance contracts to the appropriate records.
- tracing the selected transactions to supporting documents and testing the related receivables and payables.
- obtaining written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Pools, Associations, and Syndicates

6.58 Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs 6.50–.57 generally applies to audits of participating entities. Pools, associations, and syndicates often issue audited financial statements to participating entities, and auditors of participating entities may use the report of the independent auditor of the pool, association, or syndicate in their audits. AU section 543 provides guidance for such use.

Reinsurance Intermediaries

6.59 Reinsurance intermediaries' involvement may include evaluation, underwriting, negotiations, and fund transfers. The assuming and ceding entities normally coordinate their control activities with those of the intermediaries.

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[6] See footnote 2 to paragraph 6.48.

6.60 An entity may delegate to a reinsurance intermediary the performance of the procedures described in the sections "Internal Control of the Ceding Entity," paragraphs 6.42–.47, and "Internal Control of the Assuming Entity," paragraphs 6.48–.49. Normally an entity has procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided to the independent auditor in those sections may be applied.

6.61 In addition to the functions discussed in the previous paragraphs, a reinsurance intermediary may be authorized to collect, hold, disburse, or remit funds on behalf of an insurance entity. The insurance entity controls normally provide reasonable assurance that the reinsurance intermediary is adequately performing those functions; safeguarding the funds and, if required, appropriately segregating them; and settling accounts on a timely basis. The insurance entity may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls that relate to those functions. The auditor of the insurance entity should assess control risk in this area as described in chapter 4 of this guide.

6.62 The auditor may read the intermediary clauses in an assuming entity's reinsurance contracts.[7] Such clauses, which identify the specific intermediaries or brokers involved in negotiating the contracts, communicating information, and transmitting funds, should state clearly whether payment to the intermediaries constitutes payment to the other parties to the reinsurance contracts. An example of such a clause, under which the reinsurer assumes the credit risks in the transmission of reinsurance funds, follows:

> _________ is hereby recognized as the Intermediary negotiating this contract. All communications (including but not limited to notices, statements, premiums, return premiums, commissions, taxes, losses, loss adjustment expenses, salvages, and loss settlements) relating thereto shall be transmitted to the ceding company or the reinsurers through _________________. Payments by the ceding company to the Intermediary shall be deemed to constitute payment to the reinsurers. Payments by the reinsurers to the Intermediary shall be deemed to constitute payment to the ceding company only to the extent that such payments are actually received by the ceding company.

Accounting for Foreign Property and Liability Reinsurance

6.63 The promulgation of rules and regulations by state insurance departments and the adoption of specialized insurance industry accounting standards by the FASB have resulted in considerable uniformity in accounting practices in the insurance industry in the United States. Outside the United States, insurance accounting and reporting practices vary widely, although the global convergence to International Financial Reporting Standards is helping to promote consistency.[*] The diversity in insurance accounting and reporting practices of foreign insurance entities has led to questions on how U.S. insurance entities should account for property and liability reinsurance assumed from foreign entities (foreign reinsurance).

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[7] Refer to "Auditing Procedures for the Ceding Entity" in paragraphs 6.50–.53.

[*] See footnote * in the heading above paragraph 6.22.

6.64 Reinsurers assuming business from domestic entities have historically had sufficient information to monitor and account for contract results. In contrast, some reinsurers assuming business from foreign entities do not receive such information, because in some foreign jurisdictions, insurance entities' accounting and reporting practices concerning periodic recognition of revenue and incurred claims are substantially different from U.S. practices. Therefore, reinsurers assuming business from foreign ceding entities cannot always obtain sufficient information to periodically estimate earned premiums for the business assumed from the foreign ceding entities.

6.65 A significant amount of reinsurance is transacted through syndicates organized by Lloyd's of London. Lloyd's syndicates report the amounts of premiums, claims, and expenses recorded in an underwriting account for a particular year to the assuming entities that participate in the syndicates. The syndicates generally keep accounts open for three years. Traditionally, three years have been necessary to report substantially all premiums associated with an underwriting year and to report most related claims, although claims may remain unsettled after the account is closed. A Lloyd's syndicate typically closes an underwriting account by reinsuring outstanding claims on that account with a syndicate for the next underwriting year. The ceding syndicate pays the assuming syndicate an amount based on the unearned premiums and outstanding claims in the underwriting account at the date of the assumption and distributes the remaining balance to its participants.

Current Practices

6.66 Three methods are currently used in the United States to account for foreign property and liability reinsurance: the periodic method, the zero balance method, and the open year method.

Periodic Method

6.67 The periodic method of accounting for reinsurance provides for current recognition of profits and losses. It is used when ultimate premiums and the period of recognition can be reasonably estimated currently. Premiums are recognized as revenue over the policy term, and claims, including an estimate of claims IBNR, are recognized as they occur. The periodic method is consistent with current practice for primary insurance and domestic reinsurance for which sufficient information is available to reasonably estimate and recognize earned premiums and related claims. (Refer to FASB ASC 944.)

6.68 Some foreign ceding entities maintain the information necessary to estimate earned premiums, incurred claims, and related expenses currently. As a result, U.S. reinsurers doing business with these foreign ceding entities are able to account for reinsurance assumed by applying the same periodic method of accounting that they use to account for domestic reinsurance. Although not all foreign ceding entities maintain and report current information necessary to estimate earned premiums, incurred claims, and related expenses, some U.S. reinsurers have sufficient experience with the foreign business assumed to estimate earned premiums. When earned premiums can be estimated, sufficient information usually exists to estimate incurred claims and related expenses. Anticipated results based on either the reinsurer's experience or reported data make it possible to reasonably estimate underwriting results and use the periodic method.

Zero Balance Method

6.69 Many foreign ceding entities do not maintain the information necessary to estimate earned premiums. As a result, U.S. reinsurers doing business with these foreign entities generally are not able to apply the periodic method of accounting. Some of these entities use the zero balance method, which is a modified cash basis of accounting. This method is similar to the cost recovery method described in FASB ASC 944 and the FASB ASC glossary. Because of the inherent lag in reporting claims, profits reported by foreign ceding entities in early years often exceed the total profits that will ultimately be realized. To avoid reporting overstated profits, entities using this method adjust the records with arbitrary provisions for claims incurred in amounts that exactly offset the cash basis profits.

Open Year Method

6.70 Under the open year method, underwriting results of foreign reinsurance are not included in the income statement until sufficient information becomes available to provide reasonable estimates of earned premiums. The open year method is similar to the deposit method as described in FASB ASC 340-30. Because the measurement period extends over more than one accounting period, premiums, claims, and expenses are not immediately included in operating results. Instead, they are accumulated and reported in the balance sheet as an open underwriting balance. The underwriting balance is disaggregated and reported in the income statement as premiums, claims, and expenses only when earned premiums become reasonably determinable. If it is probable that a loss has been incurred before an underwriting balance is closed, a provision for a loss generally is recorded. Examples of situations in which a provision may be recorded before an underwriting balance is closed include catastrophic losses, higher-than-expected claim frequency, significant unanticipated adverse events, or a negative open year account. The accounting treatment is similar to that for premium deficiencies described in paragraphs 2–3 of FASB ASC 944-60-25.

Comparison With Practices in Other Industries

6.71 Deferral of revenue occurs in industries that sell goods subject to rights of return. If a right of return exists, current recognition of a sale is not permitted unless the amount of future returns is reasonably estimable. If that amount is not reasonably estimable, recognition of income is postponed until the return privilege has substantially expired. Income recognition is also postponed for certain real estate sales through the use of the installment and cost recovery methods. Those methods are analogous to the open year method.

6.72 Methods that defer recognition of underwriting profits raise financial accounting issues concerning (*a*) whether premiums and claims should be reported as income currently, even though the related underwriting balance[8] is deferred, and (*b*) whether the underwriting balance should be recorded as deferred income or as an addition to claim liabilities. Most entities that follow the zero balance method record premium and claim amounts currently and defer recognition of profits by additions to claim liabilities. Although this

[8] The term *underwriting balance* refers to the excess of reported premiums over reported claims and expenses. This amount is not intended to represent income realized on a contract.

presentation provides timely information on the volume of business being conducted by the enterprise, the usefulness of the information is limited because the related profit margins are not also reported.

6.73 Current accounting literature supports alternative methods of financial presentation when profit recognition is deferred. For example, recognition as income of both revenues and related costs is deferred under the completed contract method until the contract is substantially completed. However, if either the installment method or cost recovery method is used to defer the recognition of gain on the sale of real estate, the sale and related costs are ordinarily reported on the date of the transaction. The deferred profit is reported separately in the income statement as a deduction from sales in the year the transaction occurs and as a separate item of revenue in future years' income statements, when the profit is recognized.

6.74 Proponents of presenting premiums, claims, and expenses in the income statement when the amounts are reported to the reinsurer point out that excluding those amounts from the income statement until an underwriting year is closed does not reflect the economic substance of current period activities under the reinsurance contract. In response to criticism that presentation of the amounts in the income statement may cause profit margins to be misstated, they argue that disclosure of profits deferred and profits recognized provides sufficient information for users to evaluate operating results.

6.75 Proponents of reporting deferred amounts in the balance sheet until the profits relating to the underwriting year are recognized point out that the income statement generally should reflect profit margins associated with the premium volume reported in the income statement, and that this can best be done by recognizing the related premiums in the periods the profits are recognized. They acknowledge that premiums, claims, and expenses associated with a contract in a period may be important information to users, but they argue that the information could be disclosed in the notes to the financial statements or in the statement of cash flows to avoid misstating the profit margins.

6.76 The periodic method should be used to account for foreign reinsurance except in the circumstance described in paragraph 6.78.

6.77 If, due to local revenue recognition policies, the foreign ceding entity cannot provide the information required by the assuming entity to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with accounting principles generally accepted in the United States of America, then the open year method should be used.[9] The presence of uncertainties that may be inherent in estimating earned premiums is not an acceptable basis for using the open year method. As discussed in paragraph 6.71, premiums, claims, commissions, and related direct taxes should not be reported currently as income under the open year method; instead, they should be included in the open underwriting balance to which they pertain. The underwriting balances should be aggregated and included in the balance sheet as a liability. Each underwriting balance should be kept open until sufficient information becomes available to record a reasonable estimate of earned premiums. The underwriting balance should be disaggregated and reported in the

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[9] If the foreign ceding entity maintains supplementary records that are sufficient to reasonably estimate earned premiums currently, then the U.S. assuming entity should obtain the necessary information and use the periodic method to account for the foreign reinsurance.

income statement as premiums, claims, commissions, and related direct taxes when earned premiums are reasonably determinable.

6.78 If it becomes probable that a loss has been incurred before an underwriting balance is closed, a provision for the loss should be recorded.

6.79 The periodic and open year methods are not interchangeable in the same circumstances. The periodic method should be used to account for foreign reinsurance. Only if reasonable estimates cannot be made currently, for the reason discussed in paragraph 6.78, should the open year method be used. The periodic and open year methods are not alternative accounting principles as discussed in FASB ASC 250, *Accounting Changes and Error Corrections*. Rather, one or the other is to be used depending on the circumstances. As such, changes between these methods are not accounting changes. In addition, changes from the periodic method to the open year method would be seldom.

6.80 The zero balance method should not be used because it results in misstatement of the income statement by arbitrarily recognizing revenues and costs. The method also causes the profit to be reported in periods other than those in which the related premiums, claims, and expenses are reported.

Disclosures

6.81 Disclosure in the financial statements of an insurance entity's accounting policies should include a description of the methods used to account for foreign reinsurance. In addition, for foreign reinsurance accounted for by the open year method, the following should be disclosed for each period for which an income statement is presented:

- The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances
- The additions to underwriting balances for the year for reported premiums, claims, and expenses

Also, the amounts of premiums, claims, and expenses in the underwriting account should be disclosed for each balance sheet presented.

Exhibit 6-1

Topic D-54, *EITF Abstracts*, FASB Staff Announcements Regarding Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination[1]

This exhibit is included because it provides useful background information from the EITF.

On ***November 14, 1996***, a FASB representative made the following announcement at the EITF meeting:

> The Insurance Companies Committee of the AICPA has notified the FASB staff that questions have been raised regarding whether FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, or APB Opinion No. 16, *Business Combinations*, should be applied to guarantees of the adequacy of liabilities existing at the acquisition date of a business combination, whether or not they are identified, for losses and loss adjustment expenses of short-duration insurance or reinsurance contracts of insurance enterprises (reserve guarantees) when the insurance enterprise is acquired in a business combination accounted for as a purchase. It appears that certain provisions of Statement 113 and Opinion 16 conflict with regard to accounting for those reserve guarantees.
>
> Reserve guarantees may be provided by a seller to indemnify a purchaser for unanticipated increases in the liabilities for losses and loss adjustment expenses of the subject insurance enterprise. They are most often provided with regard to liabilities for losses and loss adjustment expenses for coverages with long payout periods (long-tail coverages) for which the ultimate liability and/or the timing of the payout is difficult to estimate (for example, liabilities for losses and loss adjustment expenses relating to environmental and asbestos exposures). The selling and purchasing enterprises may, or may not, be insurance enterprises, and similar guarantees are provided in a business combination accounted for as a purchase that does not involve an insurance enterprise.

The scope of this announcement is limited to the accounting by a purchaser for reserve guarantees relating to the adequacy of liabilities existing at the acquisition date of a business combination, whether or not they are identified, for short-duration insurance contracts of an insurance enterprise when provided by a seller in a business combination accounted for as a purchase in accordance with the provisions of Opinion 16. This announcement should not be applied to a business combination accounted for as a pooling of interests or to other transactions that are not within the scope of Opinion 16, such as spin-offs or initial public offerings.

The FASB staff believes that a purchaser, when accounting for reserve guarantees provided by a selling enterprise in a business combination accounted for as a purchase under the provisions of Opinion 16, should *not* apply paragraphs 22–24 of Statement 113, which address retroactive reinsurance arrangements. Reserve guarantees may be, and often are, provided between enterprises that are not insurance enterprises. The staff does not view reserve guarantees as being different from other guarantees of the existence of assets or the adequacy of liabilities often provided by the seller in a business combination accounted for as a purchase. The staff therefore believes that guarantees should be accounted for consistently regardless of whether or not the seller or purchaser is an insurance enterprise.

The FASB staff believes that changes in the liabilities for losses and loss adjustment expenses of the purchaser resulting from the continuous review process and the differences between estimates and payments for claims should be recognized in income by the purchaser in the period in which estimates are changed or payments are made in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; this includes those liabilities acquired in a business combination and subject to the reserve guarantee. The purchaser should at the same time recognize a receivable for the amount due from the seller under the reserve guarantee, subject to management's assessment of the collectability of that amount, with a corresponding credit to income. Changes in the balance of the receivable that occur subsequent to recording the business combination should be included in income in the period that the estimates are changed (or payments are received, if resulting from differences between estimates and payments) and should not affect the acquiring enterprise's accounting for the business combination.

The Task Force observed that this announcement should be applied either as a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, or prospectively to new business combinations entered into after November 14, 1996.

The SEC Observer noted that the SEC staff believes it is preferable to present the effects of the loss guarantee on a gross rather than net basis. The SEC Observer noted that any receivable from the seller should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or SEC Industry Guide 6 disclosures. The SEC Observer also expressed a preference that (1) any expense associated with increased reserves be reported as a component of other claim losses and loss adjustment expenses, and (2) other claim losses and loss adjustment expenses not be reduced by the effect of the reserve guarantee.

However, after discussion of these preferences with the Task Force, the SEC staff indicated that it would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information. In addition, the SEC staff believes the effects of such an arrangement on operations and cash flows should be clearly disclosed in management's discussion and analysis.

At the ***November 20, 1997*** meeting, FASB representatives announced that the FASB staff has received questions about whether *EITF Abstracts*, Topic No. D-54, *Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination*, applies to the purchaser's accounting for an arrangement in which the *seller* obtains reinsurance from a *third-party* reinsurer who agrees to directly indemnify the *purchaser* for increases in the liabilities for losses and loss adjustment expenses that existed at the acquisition date of a purchase business combination. The staff believes that the applicability of Topic D-54 to that and other arrangements that have circumstances that are similar to, but not the same as, the circumstances addressed in Topic D-54 should be determined based upon the specific facts and circumstances.[2] In order for the purchaser to apply the provisions of Topic D-54:

1. The seller must agree to participate in increases in the liabilities for losses and loss adjustment expenses that existed at the acquisition date of the purchase business combination. The seller may agree to indemnify the purchaser without remaining directly obligated for increases in the liabilities (for example, by funding its obligation through a reinsurance arrangement).

2. The guarantee arrangement between the purchaser and the seller must be contemporaneous with, and contingent on, the purchase business combination. The specific facts and circumstances should be considered in determining whether the guarantee arrangement is contemporaneous with the purchase business combination. The staff observes that to be contemporaneous, the guarantee arrangement should commit to *all* significant terms simultaneous with the consummation date of the purchase business combination. The absence of agreement on the significant terms, or the intention to establish or amend those terms at a later date, would result in the application of the provisions of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* to that guarantee arrangement. The fact that the purchaser is at risk for the subject increases in the liabilities for losses and loss adjustment expenses for any period after the effective date of the purchase business combination would indicate that the guarantee arrangement was not contemporaneous with that combination.

Illustrations

Following are explanations of how the above factors would be applied to illustrative guarantee arrangements between the seller and the purchaser, or between the seller, the purchaser, and one or more third parties:

1. Topic D-54 applies to a guarantee arrangement that is entered into contemporaneously with a purchase business combination in which the seller obtains a third-party indemnification (for example, a reinsurance arrangement) to reimburse the purchaser directly for unexpected increases in the liabilities for losses and loss adjustment expenses. However, the purchaser should apply the provisions of Statement 113 to an arrangement entered into directly by the purchaser with a third-party reinsurer because such an arrangement cannot be viewed as being contingent on the purchase business combination and because the seller has not participated in the arrangement.

2. The purchaser should apply Statement 113 to a guarantee arrangement that the seller and the purchaser enter into after the purchase business combination (regardless of whether the guarantee arrangement is in the form of a reinsurance arrangement) because that guarantee arrangement would not be contemporaneous with the purchase business combination.

Observation Related to Seller's Accounting

The staff also observes that the *selling* enterprise should apply the provisions of Statement 113 (assuming that the seller is an insurance enterprise to which the provisions of Statement 113 apply) to a reinsurance arrangement that it enters into before or after a purchase business combination, even if the *purchaser* is identified as the direct beneficiary of that reinsurance arrangement.

Business Combinations

Statement 141, which supersedes Opinion 16, was issued in June 2001. Statement 141 prohibits the use of the pooling-of-interest method for all business combinations initiated after June 30, 2001.

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[1] This exhibit is taken from the FASB EITF Abstracts and is included in its entirety for completeness. Portions of this discussion can be found at FASB ASC 944-805-S99.

[2] This announcement is combined with Topic D-54 in *EITF Abstracts*.

Chapter 7

Taxes[1]

Federal Income Taxation

7.01 In general, a property and liability insurance entity is subject to the same federal income tax laws that apply to other commercial enterprises. There are, however, additional sections of the Internal Revenue Code (IRC) and related Treasury regulations that apply specifically to property and liability insurers. Sections 831 and 832 of the IRC apply to all property and liability insurance entities. This chapter is intended to familiarize the auditor with significant and unique features of property and liability insurance taxation including the provisions of the Tax Reform Act of 1986, the Omnibus Budget Reform Act of 1990, and the Pension Funding Equity Act of 2004.

7.02 In addition, the following regulations may effect regulations that have already been issued. These summaries are not necessarily inclusive of potential effects on an insurance enterprise.

- *The Omnibus Budget Reconciliation Act of 1993* enacted IRC Section 197, and requires that acquired intangible assets such as insurance in force, goodwill, and going concern value, be amortized by the straight-line method over 15 years. Additionally, specific rules apply to assumption reinsurance transactions and tax deferred acquisition costs. Moreover, corporate tax rates increased from 34 percent to 35 percent.
- *The Small Business Job Protection Act of 1996* provides market value accounting for modified guaranteed contracts.
- *The Health Insurance Portability and Accountability Act of 1996* changed the net operating loss carryback and carryforward provisions.
- *The Taxpayer Relief Act of 1997* reduced the tax loss carryback from 3 to 2 years and increased the carryforward from 15 to 20 years, as well as changing the general business credit carry periods to 1 year back and 15 years forward.

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[1] For audits of issuers, as defined by the Sarbanes-Oxley Act of 2002, and other entities when prescribed by the rules of the Securities and Exchange Commission (SEC) (collectively referred to as *issuers*), Section 202 of the Sarbanes-Oxley Act of 2002 and the SEC Rule *Strengthening the Commission's Requirements Regarding Auditor Independence*, require that an issuer's audit committee preapprove all audit and nonaudit services provided to the issuer by the auditor. This includes tax services.

On July 26, 2005, the Public Company Accounting Oversight Board (PCAOB) issued Release No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees*. Subsequently, a number of related releases and a concept statement are addressing technical amendments and implementation schedules. Finally, a question and answer document was issued to provide further application clarity. For specifics, see the PCAOB website at www.pcaobus.org. Among other matters, the rules treat a registered firm as not independent of a public entity audit client if the firm, or an affiliate of the firm, provided any service or product to an audit client for a contingent fee or a commission, or received from an audit client, directly or indirectly, a contingent fee or commission. The rules also treat such a firm as not independent if the firm, or an affiliate of the firm, provided assistance in planning, or provided tax advice on, certain types of potentially abusive tax transactions to an audit client or provided any tax services to certain persons employed by an audit client. Further, the rules require registered public accounting firms to provide certain information to audit committees in connection with seeking preapproval to provide nonprohibited tax services.

- *The IRS Restructuring Act of 1998* contains general corporate impacts that may affect property and liability entities.
- *Revenue Procedure 2002-46* provides guidance on the deduction of premium-related expenses and provides a safe harbor for the deduction of premium-related expenses by property and liability insurers. The expenses must be variable in amount and must be directly related to the premium written.
- *The American Jobs Creation Act of 2004*, effective October 2004, contains changes to a variety of areas that affect insurance entities, including but are not limited to, unfunded deferred compensation plans, new disclosure and penalty regimes for reportable transactions (tax shelters), distributions from policyholder and shareholder surplus accounts, transition repeal of the Foreign Sales Corporation/Extraterritorial regime, and foreign earnings taxation (including tax credits and repatriation). Additionally, because foreign related party reinsurance arrangements may be used as a technique for eroding the U.S. tax base, the American Jobs Creation Act of 2004 amends IRC Section 845(a) to clarify that the IRS has the authority to allocate, recharacterize, or make any other adjustment to items of each party to a reinsurance agreement, in order to reflect the proper amount, source, or character of the item.
- *The American Recovery and Reinvestment Act of 2009*. In February 2009, President Obama signed legislation designed to work hand in hand with the Emergency Economic Stabilization Act of 2008 to stimulate the U.S. economy. The Recovery Act is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly.

Provisions of the Tax Reform Act of 1986 on Property and Liability Insurance Entities

7.03 *Loss-reserve discounting.* Unpaid losses, including loss adjustment expenses, of a property and liability insurance entity are subject to discounting for tax purposes. As a result, the deduction for unpaid losses is limited to the increase in the amount of discounted unpaid losses. The amount of discounted unpaid losses is computed annually with respect to unpaid losses in each line of business (as contained in Schedule P of the annual statement) for each accident year. The discount periods are generally three years for property lines and ten years for liability lines of business.

7.04 Discounting methodology is specified in the IRC. The amount of the discounted unpaid losses is the present value of such losses determined by using (*a*) the undiscounted loss reserves, (*b*) an applicable rate of interest, and (*c*) the pattern of the payment of claims.

7.05 Generally, the amount of the undiscounted unpaid losses subject to discounting is that shown in the annual statement. However, in some cases, reserves (such as workers' compensation) are already discounted for annual statement purposes. The Tax Reform Act of 1986 requires that these reserves be grossed up and that an undiscounted loss reserve be calculated. The undiscounted amount of the loss reserve is used as the amount of unpaid losses to which the discounting rules are applied. Insurance entities are permitted to gross up these discounted loss reserves for tax purposes only if the discounting for annual statement purposes is identified as such and the discounting factors that were used are explained in the annual statement. In addition, tax reserves cannot exceed annual statement reserves due to differing discount rates.

7.06 The interest rate to use in calculating the discounted reserve is an annual rate determined by the Secretary of the Treasury. The annual rate for any calendar year is a rate equal to 100 percent of the average of the applicable federal midterm rates effective at the beginning of each of the calendar months in the test period. The test period is the most recent 5 year period ending before the beginning of the year for which the determination is made. Once an interest rate assumption is established for unpaid losses in a particular accident year, it continues to be used without change as claims for the accident year are paid.

7.07 The applicable loss-payment pattern is determined by the Secretary of the Treasury for each line of business by reference to the historical loss-payment pattern. Generally, the payment patterns are determined every 5 years based on published historical aggregate-loss-payment data or, at the entity's election, each year based on its own historical loss-payment experience. Once a payment pattern has been applied to a particular accident year, it cannot be redetermined to adjust for more recent information. All losses are considered as being paid in the middle of the year. In place of the loss-payment-pattern provisions described previously, an insurance entity can make an irrevocable election to utilize its own historical loss-payment pattern (for example, the most recent experience as reported in its annual statement) in applying the general loss discounting rules for a taxable year. The election is made for all lines of business for any determination year and applies for that determination year and the 4 succeeding calendar years. The determination year is defined as being calendar year 1987 and each fifth succeeding calendar year thereafter (such as 1987, 1992, 1997, and so forth). No election is permitted for any international or reinsurance line of business.

7.08 *Unearned premium reserve.* Under prior law, the entire annual change in a property and liability insurance entity's unearned premium reserve was taken into account in computing its taxable income. In addition, property and liability insurers are entitled to deduct the expenses of issuing and selling new policies, such as policy acquisition expenses. Congress believed that allowing both a deferral of unearned premiums and a current deduction for the corresponding policy acquisition costs resulted in a significant mismatching of income and expense.

7.09 To provide for deferral of policy acquisition costs, the Tax Reform Act of 1986 permits only 80 percent of the annual change in the unearned premium reserve to be used in determining taxable income for taxable years beginning after December 31, 1986, for most lines of business. For certain financial guarantee businesses, the limitation is 90 percent. Congress deemed that the 20 percent not taken into account approximates policy acquisition costs. For example, in 1987, if an insurance entity's unearned premium reserve increases from $50,000 to $60,000, the net deduction for unearned premiums will be $8,000 ($60,000 less $50,000 times 80 percent). Similarly, if the unearned premium reserve decreases in 1988 from $60,000 to $40,000, the insurance entity will be required to include $16,000 (rather than $20,000, as under prior law) in determining taxable income.

7.10 *Dividends and tax-exempt interest.* The Tax Reform Act of 1986 requires a property and liability insurance entity to prorate a specified portion of its investment income by reducing the deduction for losses incurred by 15 percent of its tax-exempt interest income and the deductible portion of dividends received. Dividends received from affiliates that are eligible for the 100 percent dividends-received deduction (DRD) are also subject to proration if such dividends are funded by tax-exempt interest income or by dividends not eligible for the 100 percent DRD. The proration rule applies to taxable years beginning after December 31, 1986, but only to tax-exempt interest and dividends received or accrued on bonds or stocks acquired after August 7, 1986.

7.11 *Small property and liability insurance entities.* Among other matters, the Pension Funding Equity Act of 2004 changed certain provision of the tax code defining tax-exempt status. For entities other than mutual property and casualty entities, annual gross receipts, determined on a controlled group basis, must not exceed $600,000 and premiums received must be greater than 50 percent of gross receipts. This premium requirement determines that nonpremium (for example, investment) income must be $300,000 or less. For a mutual property and casualty entity, annual gross receipts must not exceed $150,000 and annual premiums must be greater than 35 percent of gross receipts, provided that certain requirements are met.[2]

7.12 The Tax Reform Act of 1986 enacted a provision that allows both mutual and stock property and liability entities to elect to be taxed only on investment income under certain conditions. The Pension Fund Equity Act eliminated a $350,000 floor such that the election is available if net written premiums do not exceed $1,200,000. Additionally, the Pension Funding Equity Act changed the definition of a control group by adding the requirement to include the receipts of foreign and tax-exempt corporations in the control group.

7.13 *Protection against loss account.* Prior to the Tax Reform Act of 1986, mutual property and liability insurance entities were permitted a protection against loss (PAL) account deduction. The PAL account, which was originally enacted to provide for the cyclical nature of the industry, is a memorandum account that allowed a mutual property and liability insurer to defer a portion of its underwriting income.

7.14 In an attempt to reduce the differences between mutual and stock entities, the Tax Reform Act of 1986 repeals the deduction for additions to the PAL account effective for taxable years beginning after December 31, 1986. Amounts in the PAL account at the close of the last taxable year beginning before January 1, 1987, are included in income in the same manner as under prior law.

7.15 *Alternative minimum tax.* The Tax Reform Act of 1986 repealed the corporate add-on minimum tax and replaced it with an alternative minimum tax (AMT). In addition, the Tax Reform Act of 1986 requires a property and liability insurance entity to take into account its AMT liability and regular

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[2] The requirements are that no employee of the entity or member of the employee's family is an employee of any other entity that is exempt from tax under Section 501(C)(15). The receipt and employee limitation for mutual entities is intended to address the inappropriate use of tax-exempt insurance entities to shelter investment income. For example, it is intended that the provision not permit the use of small entities with common owners or employees to shelter investment income for the benefit of such owners or employees.

tax liability in making estimated tax payments. As of 1990, adjusted current earnings (ACE) is used for calculating the AMT.

7.16 *Adjusted current earnings.* The ACE is equal to taxable income plus a number of adjustments and preferences, the most significant of which for property and casualty entities will be the inclusion of the untaxed portion of tax-exempt interest and the DRD applicable to portfolio stocks (70 percent DRD). The DRDs relating to entities in which the taxpayer owns at least 20 percent but less than 80 percent (80 percent DRD) and for which the taxpayer owns 80 percent or more (100 percent DRD) are not included in ACE. Alternative minimum taxable income (AMTI) will be increased by 75 percent of the amount by which ACE, rather than book income, exceeds AMTI before this adjustment. For many property and liability entities, ACE can be approximated by simply adding 75 percent of tax-exempt interest and 75 percent of the 70 percent of the DRD to regular taxable income.

Provisions of the Pension Funding Equity Act of 2004 on Property and Liability Insurance Entities

7.17 In general, the Provisions of the Pension Funding Equity Act of 2004 contains significant changes to Section 501(c)(15) tax-exempt insurance entities and modifies the definition of a property casualty insurance entity. (Additionally, in general, it repealed the Section 809 differential earnings adjustment for mutual life insurance entities.)

7.18 *Defining a property casualty (liability) insurance company.* Section 816(a) of the IRC (Life Insurance) defines an *insurance company* as any company "for which more than half of the business during the tax year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." The definition is based on the company's *primary and predominant business activity*, that is, other pursuits such as investment activities cannot outweigh insurance activities. Prior to the Provisions of the Pension Funding Equity Act of 2004, this definition specifically applied to life insurance entities. The Provisions of the Pension Funding Equity Act of 2004 creates a uniform definition of an insurance company by amending Section 831 of the code to include the definition stated in Section 816(a). This specified definition of a property casualty insurance company may affect property casualty insurance entities that have substantial amounts of investment income relative to their insurance income.

7.19 *Tax-exempt status of a property casualty insurance company.* (Section 501(c)(15)). Among other matters, the Provisions of the Pension Funding Equity Act of 2004 changes the requirements for premium and nonpremium (that is, investment income) levels, specifies requirements for mutual property and casualty entities, and eliminates the premium floor for the 831(b) election—the choice to be taxed on only investment income. Additionally, the definition of a control group as defined by Section 1563(a) has been expanded to require the receipts of foreign and tax-exempt corporations. In general, except as provided in the Provisions of the Pension Funding Equity Act of 2004, the effective date for changes are for tax years beginning after December 31, 2003, with some transition provisions with respect to certain entities. The changes to tax-exempt status under section 501(c) may cause entities that were tax exempt in 2003 to become taxable in 2004. These entities generally should evaluate the implications of a transition from tax-exempt to taxable status. Consideration may be given to the effect of any change on accounting methods, accounting periods, carryover of tax attributes, filing requirements, and personal holding company taxes. Consideration could also be given to any financial statement implications, including 2003 filings with state insurance commissioners.

Statutory Accounting Practices and Taxable Income

7.20 A property and liability insurance entity's taxable income is based in large part on its statutory financial statements. The underwriting and investment exhibit of the annual statement approved by National Association of Insurance Commissioners is accepted by the IRS as the net income of the entity; and insofar as it is not inconsistent with the provisions of the IRC, the exhibit is recognized and used as a basis for determining the gross amount earned from investment and underwriting income for tax purposes.

7.21 Statement of Statutory Accounting Principles (SSAP) No. 10R, *Income Taxes–Revised, A Temporary Replacement of SSAP No. 10*,[*] notes that "only adjusted gross deferred tax assets that are more likely than not (a likelihood of more than 50 percent) to be realized shall be considered in determining admitted adjusted gross deferred tax assets." SSAP No. 10R paragraphs 5 and 7 note that, under statutory accounting principles (SAP), "A reporting entity's balance sheet should include deferred income tax assets (DTAs) and liabilities (DTLs), the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109 . . . Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus). Admitted adjusted gross DTAs and DTLs shall be offset and presented as a single amount on the statement of financial position." Under SAP, the adjusted gross DTA is also subject to an additional admissibility test to determine how much of the gross deferred tax asset may be admitted.

7.22 There are several other unique and prominent similarities and differences between statutory and taxable income. First, commissions, premium taxes, and other costs of acquiring new business are fully deductible for tax purposes in the year that they are incurred. However, using only 80 percent of the unearned premium reserves to determine earned premiums for tax purposes (see paragraphs 7.08–.09) provides an offset. Second, incurred losses tend to be reduced by the use of discounted loss reserves (see paragraphs 7.03–.07). Third, direct charges or credits to statutory surplus are not included in determining taxable income. They include premiums past due from agents—unless they are bona fide bad debts currently chargeable to statutory expense—and the provision for unauthorized reinsurance.

7.23 Although most of the accounting practices for determining taxable income as prescribed by the IRC follow statutory accounting practices, there are items that are always excluded from or are deductible in computing taxable income, such as tax-exempt interest received on certain bonds, and the DRD. The IRC and regulations of the IRS also differ from statutory practices in certain respects for policyholder dividends and deposit premiums.

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[*] Statement of Statutory Accounting Principles (SSAP) No. 10R, *Income Taxes–Revised, A Temporary Replacement of SSAP No. 10*, is effective for 2009 annual financial statements and 2010 interim and annual financial statements only. In the event subsequent deferred tax asset admission guidance is not adopted by the end of this statement's effective period, SSAP No. 10 is reinstated as authoritative guidance for accounting and reporting of income taxes for statutory financial statements.

7.24 *Policyholder dividends.* Under statutory accounting practices, policyholder dividends are charged to expense on the date they are declared; the IRC permits policyholder dividends to be deducted on the date declared, the date payable, or the date paid, as long as the chosen method is consistently followed.

7.25 *Deposit premiums.* Deposit premiums are provisional payments by policyholders that are adjusted when the policies expire, based on the coverage provided. They are most commonly used for workers' compensation insurance. Statutory accounting practices allow several methods of recognizing deposit premiums. For federal income tax purposes, the includable portion of the premium is the amount received, less the amount of unabsorbed premium deposits that the entity would be obligated to return to its policyholders at the close of the taxable year if all its policies were terminated at that date.

Special Income Tax Provisions

7.26 *Capital losses.* The IRC treats the deductions for capital losses of property and liability insurers differently from those of other corporate taxpayers in certain unusual circumstances. Property and liability insurers may claim ordinary deductions for capital losses resulting from the sale or exchange of capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Insurance entities use a prescribed calculation to determine whether securities were sold to meet abnormal losses. Capital losses are ordinary deductions to the extent that gross receipts from assets sold do not exceed the excess of cash-basis income over cash-basis expense.

U.S. Generally Accepted Accounting Principles Accounting for Income Taxes

7.27 The primary literature for U.S. generally accepted accounting principles (GAAP) accounting for income taxes is Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740, *Income Taxes*.

7.28 FASB ASC 740 prescribes an asset and liability method of accounting for income taxes. Under the asset and liability method, the emphasis in accounting for income taxes is on the balance sheet rather than on the income statement. The asset and liability method accounts for deferred income taxes by applying enacted statutory tax rates in effect at the balance sheet date to the temporary differences between the recorded financial statement balances and the related tax bases of assets and liabilities (under U.S. GAAP, computed pursuant to FASB ASC 740). The resulting deferred tax liabilities and assets are adjusted to reflect changes in tax laws and rates in the period of enactment.

Basic Principles of Accounting for Income Taxes

7.29 *Determine current tax liability or asset.* Under U.S. GAAP,[3] FASB ASC 740-10-25-2 states that a tax liability or asset is recognized based on the

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[3] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10-65-1 defers the effective date of FASB Interpretation No. 48 for certain *nonpublic enterprises* (as defined in paragraph 289, as amended, of FASB Statement No. 109, *Accounting for Income Taxes*) to the annual financial statements for fiscal years beginning after December 15, 2008. However, nonpublic

(continued)

provisions of FASB ASC 740 for the estimated taxes payable or refundable on tax returns for the current and prior years. Under FASB ASC 740, the contingency concepts discussed in FASB ASC 450, *Contingencies*, no longer applies to recognition. Under SAP, a current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year. Under SAP, SSAP No. 10R paragraph 3 defines current income taxes as

a. current year estimates of federal and foreign income taxes. . .based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets*;

b. amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in SSAP No. 3, *Accounting Changes and Corrections of Errors*.

7.30 Under FASB ASC 740, the asset and liability method accounts for deferred income taxes by applying provisions of the enacted tax law in effect at the balance-sheet date to the temporary differences between the recorded financial statement balances and the related tax bases of assets and liabilities (under U.S. GAAP, computed pursuant to FASB ASC 740.) The resulting deferred tax liabilities and assets are adjusted to reflect changes in tax laws and rates.

7.31 *Determine temporary differences*. To determine each year's deferred taxes, the first step is to identify temporary differences and operating loss and tax credit carryforwards. Temporary differences are differences between the tax return bases of assets and liabilities, computed pursuant to FASB ASC 740, and their financial reporting amounts. Some temporary differences cannot be identified with a particular asset or liability for financial reporting, but those temporary differences result from events that have (*a*) been recognized in the financial statements and (*b*) will result in taxable or deductible amounts in future years based on provisions of the tax law. Taxable temporary differences will result in taxable income in future years when the related asset or liability is recovered or settled. Conversely, deductible temporary differences will result in deductible amounts in future years. SSAP No. 10R paragraph 10, discusses the treatment of temporary differences, and unrealized gains and losses for computing DTAs and DTLs. Differences that will never have a tax consequence are not considered temporary differences.

7.32 *Determine deferred tax asset or liability*. The total deferred tax assets and liabilities for temporary differences and carryforwards are then measured by applying the applicable tax rate, which is the enacted tax rate to taxable income, in the periods in which the deferred tax items are expected to be settled or

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(footnote continued)

consolidated entities of public enterprises that apply U.S. generally accepted accounting principles are not eligible for the deferral. Nonpublic enterprises that have applied the recognition, measurement, and disclosure provisions of FASB Interpretation No. 48 in a full set of annual financial statements issued prior to the issuance of this FSP also are not eligible for the deferral.

Paragraphs 8 and 13 of FASB ASC 740-10-50 discuss disclosures that are and are not required for nonpublic entities, as compared to the tax disclosure requirements of public entities.

realized. Deferred tax assets are measured for each type of temporary difference and carryforward.

7.33 A tax position could result in or affect the measurement of a current or deferred tax asset or liability in the statement of financial position. Organizations adopt many tax positions relative to tax laws, including those adopted in determining whether tax is due, a refund is owed, or if a tax return needs to be filed. A entity's tax positions can change over time from a myriad of variables, for example, IRS developments, state taxing authorities, tax court cases, or a combination of multiple items.

7.34 FASB ASC 740-10-25-6 notes that an entity should initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. The term *more likely than not* means a likelihood of more than 50 percent; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any. For example, if an entity determines that it is certain that the entire cost of an acquired asset is fully deductible, the more-likely-than-not recognition threshold has been met. The more-likely-than-not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold should consider the facts, circumstances, and information available at the reporting date. The level of evidence that is necessary and appropriate to support an entity's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information.

7.35 FASB ASC 740-10-25-9 notes that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an entity should make the assessment on a position-by-position basis, but an entity could conclude that all positions in a particular tax year are effectively settled.

7.36 In addition to the aforementioned guidance, FASB ASC 740 clarifies a number of other areas surrounding the uncertainty in income taxes, including derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

7.37 Additionally, under U.S. GAAP it is necessary to determine if a deferred tax asset valuation allowance is needed. Deferred tax assets are then reduced by a valuation allowance if, based on all available evidence (both positive and negative), it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the tax benefit will not be realized. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

7.38 *Valuation allowances—sources of evidence.* Realization of the deferred tax asset in the future depends on the existence of sufficient future taxable income of the appropriate character within the carryback or carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences.

b. Future taxable income in future taxable years, exclusive of reversing temporary differences and carryforwards.

c. Taxable income in prior carryback years if carryback is permitted under the tax law.

d. Tax-planning strategies, provided the strategy is

  i. prudent and feasible.

  ii. an action that an insurance entity would normally not take in the ordinary course of business, but would take, if necessary, to prevent a tax benefit from expiring unused.

  iii. an action that would result in the realization of deferred tax assets. Paragraph A18 of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, states that only tax planning strategies that meet the more likely than not recognition threshold would be considered in evaluating the sufficiency of future taxable income for realization of deferred tax assets.

However, if after all four sources as previously described are examined, it is still more likely than not that some or all of the deferred tax asset will not be realized, then a valuation allowance should be established. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if the strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) should be included in the valuation allowance.

Under SAP, an admissibility test, rather than a valuation allowance, must be used to determine how much of the gross deferred tax assets should be admitted. SSAP No. 10R paragraph 10, notes the

> gross DTAs should be admitted in an amount equal to the sum of:
>
> *a.* Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;
>
> *b.* The lesser of:
>
> (1) The amount of gross DTAs, after the application of paragraph 10a., expected to be realized within one year of the balance sheet date; or
>
> (2) Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

c. The amount of gross DTAs, after application of paragraphs 10a and 10b, that can be offset against existing gross DTLs.

Readers should refer to *A Guide to Implementation of SSAP No. 10 on Accounting for Income Taxes: Questions and Answers*, which clarifies the admissibility calculation as well as other subjects.

7.39 Under SAP, in addition to a valuation allowance, an admissibility test must be used to determine how much of the gross deferred tax assets should be admitted. Paragraph 6 of SSAP No. 10R notes

> A reporting entity's deferred tax assets and liabilities are computed as follows:
>
> *a.* Temporary differences are identified and measured using a 'balance sheet' approach whereby statutory and tax basis balance sheets are compared;
>
> *b.* Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that 'tax and loss' bonds have been purchased;
>
> *c.* Total DTAs and DTLs are computed using enacted tax rates; and
>
> *d.* A DTL is not recognized for amounts described in paragraph 31 of FAS 109.
>
> *e.* Reduce gross DTAs by a statutory valuation allowance adjustment if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the gross DTAs will not be realized. The statutory valuation allowance adjustment,[4] determined in a manner consistent with paragraphs 20 through 25 of FAS 109,[5] shall reduce the gross DTAs to the amount that is more likely than not to be realized (the adjusted gross deferred tax assets).

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[4] The statutory valuation allowance adjustment is utilized strictly to calculate the "adjusted gross DTA." (Admittance criteria in paragraph 10 are applied to the "adjusted gross DTA.") The application of the statutory valuation allowance adjustment in SSAP No. 10R shall not result in a statutory valuation allowance reserve within the statutory financial statements.

[5] For purposes of determining the amount of adjusted gross deferred income tax assets (DTAs) and the amount admitted under paragraph 10, the admission calculation shall be made on a separate company, reporting entity basis. A reporting entity that files a consolidated federal income tax return with its parent should look to the amount of taxes it paid (or were allocated to it) as a separate legal entity in determining the admitted DTA under paragraphs 10.a. and 10.e.i. Furthermore, the DTA under these paragraphs may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent. The taxes paid by the reporting entity represent the maximum DTA that may be admitted under paragraphs 10.a. or 10.e.i., although the amount could be reduced pursuant to the group's tax allocation agreement. The amount of admitted adjusted gross DTAs under paragraphs 10.b.i. and 10.e.ii.(a) is limited to the amount that the reporting entity expects to realize within the applicable realization period, on a separate company basis. The reporting entity must estimate its separate company taxable income and the tax benefit that it expects to receive from reversing deductible temporary differences in the form of lower tax payments to its parent. A reporting entity that projects a tax loss in the applicable realization period cannot admit a DTA related to the loss under paragraph 10.b. and 10.e.ii., even if the loss could offset taxable income of other members in the consolidated group and the reporting entity could expect to be paid for the tax benefit pursuant to its tax allocation agreement.

SSAP No. 10R paragraph 10 notes that

> adjusted gross DTAs should be admitted in an amount equal to the sum of paragraphs 10.a, 10.b, and 10.c, or the amount determined in paragraphs 10.d. and 10.e.:
>
> *a.* Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year; and
>
> *b.* The lesser of:
>
> i. The amount of adjusted gross DTAs, after the application of paragraph 10a., expected to be realized within one year of the balance sheet date; or
>
> ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and
>
> *c.* The amount of adjusted gross DTAs, after application of paragraphs 10a and 10b, that can be offset against existing gross DTLs. An entity must consider the character (i.e., ordinary versus capital) of the DTAs and DTLs such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations.
>
> *d.* If the reporting entity is subject to risk-based capital requirements or is required to file a Risk-Based Capital Report with the domiciliary state, and the reporting entity's financial statements, after reflecting admitted adjusted gross DTAs calculated from the sum of paragraphs 10.a., 10.b., and 10.c. results in the company's risk-based capital level being above the following thresholds:
>
> i. The risk-based capital trend test for those entities that are subject to a risk-based capital trend-test; or
>
> ii. For those entities not subject to a risk-based capital trend test, a risk-based capital above the maximum risk-based capital level where an action level could occur as a result of a trend test (i.e. 250% for life and fraternal entities; 300% for property/casualty entities and health entities;
>
> then the reporting entity may elect to admit a higher amount of adjusted gross DTAs as calculated in paragraph 10.e.
>
> If the reporting entity is not subject to risk-based capital requirements and is not required to file a Risk-Based Capital Report with the domiciliary state, then the reporting entity shall not admit a higher amount of adjusted gross DTAs as calculated in paragraph 10.e. and shall calculate admitted adjusted gross DTAs equal to the sum of paragraphs 10.a., 10.b., and 10.c.

e. If the thresholds in paragraph 10.d. are exceeded, then adjusted gross DTAs, if elected by the reporting entity, shall be admitted in an amount equal to the sum of:

i. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years; and

ii. the lesser of:

(a) The amount of adjusted gross DTAs, after the application of paragraph 10.e.i., expected to be realized within three years of the balance sheet date; or

(b) Fifteen percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

iii. The amount of adjusted gross DTAs, after application of paragraphs 10.e.i. and 10.e.ii., that can be offset against existing gross DTLs. An entity must consider the character (i.e., ordinary versus capital) of the DTAs and DTLs such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations.

f. The increased amount (admitted adjusted gross DTA calculated from 10.e. less the sum of admitted adjusted gross DTA calculated from 10.a., 10.b., and 10.c.) of admitted assets and statutory surplus resulting from the use, if applicable, of paragraph 10.e. to calculate admitted adjusted gross DTAs:

i. Shall be separately reported in the Aggregate write-ins for gains and losses in surplus line of the Summary of Operations, Statement of Income or Statement of Revenue, as applicable.

ii. Shall be separately reported in the Aggregate write-in for special surplus funds line of Liabilities, Surplus and Other Funds; Liabilities, Capital and Surplus or Liabilities and Surplus, as applicable.

7.40 Paragraph 11 of SSAP No. 10R states

in computing a reporting entity's admitted adjusted gross DTA pursuant to paragraph 10;

a. Existing temporary differences that reverse by the end of the subsequent calendar year, within three years or during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, shall be determined in accordance with paragraphs 228 and 229 of FAS 109;

b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;

c. The amount of carryback potential that may be considered in calculating the admitted adjusted gross DTAs of a reporting entity in subparagraph 10.a. or 10.e.i. above, that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

d. The phrases "reverse by the end of the subsequent calendar year," "reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years," "realized within one year of the balance sheet date" and "realized within three years of the balance sheet date" are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

Changes in Tax Law

7.41 Under the U.S. GAAP asset and liability method, deferred taxes represent liabilities to be paid or assets to be received in the future. Accordingly, deferred tax assets and liabilities are adjusted to reflect a change in tax law or rates. The effect of the change is recognized as a component of income tax expense in the period the tax law change is enacted. Under SAP, as noted in SSAP No. 10R, changes in DTAs and DTLs attributable to changes in tax rates and tax status should be recognized as a separate component of gains and losses in surplus.

Financial Statement Presentation and Disclosure

7.42 Paragraphs 4–6 and 9 of FASB ASC 740-10-45 set forth U.S. GAAP financial statement presentation principles related to deferred tax assets and liabilities. FASB ASC 740-10-50 provides guidance on the financial statement disclosure requirements relating to income taxes applicable to all entities. As discussed in paragraphs 8 and 13 of FASB ASC 740-10-50, nonpublic entities are not required to make certain tax related disclosures that are applicable to public entities.

7.43 Separate balance sheet presentation of current refundable income taxes or income taxes payable and deferred income taxes for each tax jurisdiction (federal, state, and each foreign tax jurisdiction) should be made (for example, a federal deferred tax asset should not be netted against a state deferred tax liability). The following components of the net deferred tax liability or asset recognized in the property and liability insurer's balance sheet should be disclosed:

- The gross amount of all deferred tax liabilities
- The gross amount of all deferred tax assets

- The amount of any valuation allowance reducing the amount of deferred tax asset and any change in the valuation allowance during the period

The net change during the year in the total valuation allowance also should be disclosed.

7.44 As discussed in FASB ASC 740-10-50-3, an entity shall disclose both of the following:

a. The amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes

b. Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (see FASB ASC 740-20-45-11 and paragraph 30 of FASB Statement No. 109, *Accounting for Income Taxes*, before that statement's amendment by FASB Statement No. 141(R), *Business Combinations*)

7.45 An entity's temporary difference and carryforward information requires additional disclosure. The additional disclosure differs for public and nonpublic entities, see paragraphs 6–8 of FASB ASC 740-10-50 for the specific disclosures.

7.46 As discussed in FASB ASC 740-10-50-15, an entity shall disclose all of the following at the end of each annual reporting period presented:

a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum

   i. the gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.

   ii. the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.

   iii. the amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities.

   iv. reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position.

d. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date,

   i. the nature of the uncertainty.

   ii. the nature of the event that could occur in the next 12 months that would cause the change.

iii. an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

e. A description of tax years that remain subject to examination by major tax jurisdictions.

7.47 Examples of temporary differences of property and liability insurance entities for which a deferred tax liability is not recognized unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

- Excess book basis over the tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration.
- Undistributed earnings of a domestic subsidiary or corporate joint venture that are permanent in duration and arose in fiscal years beginning on or before December 15, 1992.

7.48 As discussed in FASB ASC 740-10-50-9, the significant components of income tax expense for continuing operations for each period presented should be disclosed, and those components would include, for example,

a. current tax expense (or benefit).

b. deferred tax expense (or benefit) (exclusive of the effects of other components listed subsequently).

c. investment tax credits.

d. government grants (to the extent recognized as a reduction of income tax expense).

e. the benefits of operating loss carryforwards.

f. tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity.

g. adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity.

h. adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

7.49 The amount of income tax expense or benefit amount allocated to (*a*) continuing operations, (*b*) discontinued operations, (*c*) extraordinary items, (*d*) other comprehensive income, and (*e*) shareholders' equity should be disclosed. For example, the amount of income tax expense or benefit attributable to certain items whose tax effects are charged or credited directly to other comprehensive income or related components of shareholder's equity, such as translation adjustments under FASB ASC 830, *Foreign Currency Matters*, or changes in the carrying amount of available-for-sale securities under FASB ASC 320, *Investments—Debt and Equity Securities*, should be separately allocated and disclosed.

7.50 Securities and Exchange Commission (SEC) registrants are required to disclose a reconciliation using percentages or dollar amounts of the current year's tax expense attributable to continuing operations to the amount of tax expense computed by applying the federal statutory tax rate to pretax income from continuing operations of the current year. The estimated amount and nature of each significant reconciling item should be disclosed. Non-SEC registrants are required to disclose the nature of significant reconciling items. This is usually satisfied by a footnote describing the nature of the reconciling items without any quantitative disclosure. This reconciliation is also required for SAP, per SSAP No. 10R paragraph 21, to reconcile the difference between the income taxes incurred and the changes in the DTAs and DTLs to the result of applying the federal statutory rate to pretax net income.

7.51 The amounts and expiration dates of net operating loss and tax credit carryforwards should be disclosed. Further, a property and liability insurance entity is required to disclose the amount of any valuation allowance for which subsequently recognized tax benefits will be allocated directly to (*a*) reduce goodwill or other noncurrent intangible assets of an acquired entity or (*b*) contributed capital.

7.52 A property and liability insurance entity that joins in the filing of a consolidated tax return with its parent and affiliates must disclose in its separately-issued financial statements the method for allocating and settling the consolidated income taxes among the members of the group, which should be in accordance with the principles in FASB ASC 740. The aggregate amount of current and deferred tax expense and any tax-related balances due to or from affiliates also should be disclosed; see paragraphs 15 and 19 of FASB ASC 740-10-50 for additional detail.

7.53 The objectives of auditing income taxes are to obtain reasonable assurance that

- the provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with the accounting principles generally accepted in the United States.
- DTLs and DTAs accurately reflect the future tax consequences of events that have been recognized in the property and liability insurance entity's financial statements or tax returns (temporary differences and carryforwards).

7.54 The independent accountant should be aware that the tax laws specific to property and liability insurance entities, as well as to general corporate taxation, can change from year to year.

7.55 Under SAP, additional disclosures are required if an entity's federal income tax return is consolidated with those of any other entity; see SSAP No. 10R paragraph 23. Refer to SSAP No. 10R paragraphs 17–23 for a complete list of statutory disclosure requirements.

Internal Control and Possible Tests of Control[6]

7.56 As part of obtaining an understanding of internal control related to income tax transactions, the auditor might consider the following factors. An entity's internal control consists of the following five elements: the control environment, risk assessment, control activities, information and communication, and monitoring as stated in paragraph .41 of AU section 314, *Understanding the*

[6] For additional discussion of internal control, including considerations of integrated audits, see chapter 2, "Audit Considerations."

Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, *Professional Standards*, vol. 1). As discussed in chapter 5, "General Auditing Considerations," the auditor should obtain a sufficient understanding of each of the five elements of the entity's internal control to assess the risks of material misstatement of the entity's financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

Control Environment

7.57 The control environment, as related to federal and state taxes of an insurance entity, represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures of the entity. Such factors that relate to federal and state tax transactions include the following:

- *a.* A single person dominates the decision-making process with regard to tax issues and tax planning strategies.
- *b.* The entity does not use an insurance tax specialist in determining its federal income tax provision.
- *c.* The entity finalizes complex business transactions before they have a qualified tax professional review the tax consequences.

Control Activities

7.58 Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit. The following are examples of typical internal control procedures and policies relating to federal and state tax payments, deferred tax amounts, and other related liabilities transactions:

- *a.* Proper authorization of transactions and activities
- *b.* Segregation of duties
- *c.* Design of adequate controls over documents and records (there is adequate control over records of temporary differences)
- *d.* Adequate safeguards of access to and use of assets and accounting records
- *e.* Independent checks on performance and proper valuation of recorded amounts

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (See paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]). Also refer to paragraph 54 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for a discussion on the extent of tests of controls.

Information and Communication

7.59 Paragraph .81 of AU section 314 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions and to maintain accountability for related assets, liabilities, and equity.

7.60 The transaction flow of accounting records for income tax payments and related liabilities encompasses all functions relating to components of taxable income and related deductions. In general, the insurance entity's general accounting system should provide adequate levels of information to determine the entity's federal and state income tax liabilities. Insurance entities will maintain detailed accounting records for any items relating to temporary differences.

Substantive Procedures

7.61 Substantive audit procedures may include the following:

- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree entries to general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.
- Examine prior year income tax returns, and ascertain the latest year for which returns have been examined. Review recent Revenue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years.
- Update or review the schedule of cumulative temporary differences, reviewing for propriety, and test the reasonableness of the income tax amounts.
- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets based upon available evidence. The auditor should recognize that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be evaluated based upon the likelihood of realization, taking into account the timing of the bad debt deduction, and the special operating loss carryforwards and carryback tax rules, if applicable.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Review classification and description of accounts to identify possible tax reporting differences, such as reserves for anticipated losses or expenses.
- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current year acquisitions of other entities and their preacquisition tax liabilities and exposures.
- Review the utilization of carryforwards.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income taxes.

- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory accounting rules for intercompany tax allocation and settlement.
- Review schedule of net operating loss and other tax credit carryforwards.
- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB Statement No. 109.
- Test the roll-forward of tax balance sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior year tax accrual to the actual filed tax return. Determine the propriety of adjustments made in this regard and consider the impact on current year's tax accrual.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB Interpretation No. 48.
- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Evaluate the adequacy of the financial statement disclosures.

Net Operating Loss and Tax Credit Carryforwards

7.62 FASB ASC 740 generally requires that the tax benefit of a loss carryforward be reported as a reduction of income tax expense.

Other Issues

7.63 The following discussion highlights other changes to current accounting practice required by FASB ASC 740 and specific implementation issues confronting the insurance industry.

Unrealized Gains and Losses

7.64 Unrealized gains and losses are considered temporary differences for which deferred taxes computed under the statement's intraperiod tax allocation provisions are measured and recorded through a direct charge or credit to other comprehensive income.

7.65 Deferred tax assets should be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax asset will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

7.66 Net unrealized gains and losses should be considered to be temporary differences. The period in which net gains and losses on marketable securities are realized is dependent upon management's future investment decisions.

Accounting for the 'Fresh Start'

7.67 The Tax Reform Act of 1986 grants insurers a "fresh start" on the difference between ending 1986 undiscounted loss reserves and beginning 1987 discounted loss reserves, meaning that such difference need not be included in post-1986 taxable income. This creates a temporary difference that will result in deductible amounts in future periods.

7.68 Under FASB ASC 740, the difference between the financial statement reserve liability and the tax basis of reserves (including fresh start) is a temporary difference.

The Alternative Minimum Tax

7.69 The AMT may be the most significant and complex aspect of the Tax Reform Act of 1986. The objective of the AMT is to ensure that no taxpayer with substantial "economic income" can avoid paying tax by using exclusions, deductions, and credits. FASB's Emerging Issues Task Force (EITF) reached a consensus, as described in EITF Issue No. 87-8, "Tax Reform Act of 1986: Issues Relating to the Alternative Minimum Tax," on several key issues relating to the accounting for the AMT under APB Opinion No. 11, *Accounting for Income Taxes*. Of primary significance was the decision to view the AMT as a separate but parallel tax system. The federal tax liability is considered to be the greater of the amount calculated under the regular tax system or the AMT system. However, the excess of the AMT over the regular tax is generally available as an AMT credit carryforward to future years.

7.70 Under FASB ASC 740, the AMT credit carryforward is reflected as a prepayment of regular tax and reported as a deferred tax asset subject to a valuation allowance.

Accounting for Income Taxes—Special Areas

7.71 FASB ASC 740 requires additional financial statement disclosures regarding temporary differences from undistributed earnings of subsidiaries and corporate joint ventures and the amounts designated as policyholders' surplus of stock life insurance entities.

Interim Financial Reporting

7.72 FASB ASC 740 eliminates the requirement to restate prior interim periods for the effects of new retroactive tax legislation. The effects of changes in tax laws or rates are to be recorded in the interim period in which the tax law change is enacted.

State Taxation

7.73 Various state governments tax property and liability insurers on premiums written and on income. Taxation methods and tax rates vary widely among the states. Many of the states apply different rates to different lines of insurance and differentiate between domestic insurers and foreign insurers.

7.74 *Premium taxes.* All states tax premiums. These taxes usually apply both to the entities that are domiciled in the state, called *domestic insurers*, and to the entities that conduct business in the state but are domiciled elsewhere, called *foreign insurers*. Some states, however, partially or totally exempt domestic insurers from premium taxes, and others allow domestic insurers special credits against premium taxes if they invest specified amounts of assets in domestic corporations. (SSAP No. 94, *Accounting for Transferable State Tax Credits*, provides guidance for credits that are consistent with the SAP statement of concepts—excluded from its scope are Certified Capital Gain Companies and Investments in Low Income Housing per SSAP No. 93, *Accounting for Low Income Housing Tax Credit Property Investments*.) The premium tax base is generally direct premiums written less returned premiums on the business within the taxing state. The tax rates vary by state.

7.75 Most states require quarterly premium tax payments and require the balance of any premium taxes due to be paid in February of the year following the year that the premiums were written (along with the filing of the annual tax return). Rather than computing the liability on a state-by-state basis, most entities estimate their total premium tax payable using their historical ratio of total premium tax expense to total premiums written. This ratio is applied to current premiums written to compute the current premium taxes for the fiscal year. The total liability is then adjusted for prepaid premium taxes to arrive at the accrued premium tax liability. The entity might consider evaluating the ratio on an annual basis, because shifts in the concentration of the entity's business from state to state and changes in state tax laws can significantly affect an insurer's premium tax liability.

7.76 *State income taxes.* In addition to premium taxes of insurance entities, some states tax the net taxable income (as defined by the respective state) of domestic insurers in one way or another. Some also tax the net taxable income of foreign insurers. Generally, however, various methods are used to avoid double taxation. The methods include (*a*) allowing the insurer to elect to be taxed on either premiums or net taxable income, (*b*) allowing a credit on one of the tax returns for taxes paid on the other, and (*c*) exempting domestic insurers from the premium tax.

7.77 States that tax the income in addition to or in place of the premium tax of property and liability insurance entities generally base the computation of taxable income on federal taxable income, with certain modifications. Apportionment and allocation of income by multistate entities are important considerations when accruing for such taxes.

7.78 The prior-year apportionment percentage is generally indicative of the current year for computing the accrual. Significant changes in the places in which the entity does business, however, can affect apportionment and may be considered when testing the adequacy and reasonableness of the accrual for state franchise or income taxes.

Chapter 8

Reports on Audited Financial Statements

Reports on Financial Statements

8.01 AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance for reports on insurance entities' financial statements prepared in accordance with the generally accepted accounting principles (GAAP) of the United States of America. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, a disclaimer of opinion, or an adverse opinion. This chapter contains a brief discussion of each of these reports, with an emphasis on illustrating issues that an auditor may encounter in auditing the financial statements of insurance entities.

> *Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards*
>
> PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes requirements and provides guidance for auditors engaged to audit both a company's financial statements and its internal control over financial reporting.

8.02 The illustrative auditors' reports in this chapter are presented to assist auditors in drafting their reports under various circumstances. Each illustration intentionally describes the same general fact situation to avoid suggesting that particular facts always lead to a particular form of opinion. The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report.

Unqualified Opinions on GAAP Financial Statements

8.03 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with GAAP. This conclusion may be expressed only if the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards or PCAOB standards. The following is an illustration of an auditor's standard report (unqualified opinion) on the GAAP basis financial statements of an insurance entity.

<u>Independent Auditor's Report</u>

> To the Board of Directors and Shareholders
> ABC Property and Liability Company
>
> We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[1] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional for nonissuers: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

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[1] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB Auditing Standards in audit reports when an auditor is engaged to perform the audit in accordance with both generally accepted auditing standards and PCAOB Auditing Standards. The Auditing Standards Board also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA website at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/RESOURCES/AUDATTEST/AUDATTESTSTNDRDS/Pages/AuditandAttestServices-Standards.aspx for more information.

[2] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing, and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Unqualified Opinions With Explanatory Language

Emphasis of a Matter

8.04 In a number of circumstances, the auditor may emphasize a matter regarding the financial statements and express an unqualified opinion. For example, the auditor may emphasize that the insurance entity is a component of a larger business entity or that it has had significant transactions with related parties, or the auditor may emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period.

Such explanatory information should be presented in a separate paragraph of the auditor's report (either preceding or following the opinion paragraph). Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion.

The following is an illustration of an unqualified opinion on the GAAP financial statements of an insurance entity with an emphasis of a matter regarding the entity's failure to meet minimum risk-based capital standards. The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. A similar paragraph could be adapted for use in an opinion on statutory-basis financial statements. They are not intended to provide criteria or other guidelines to be used by auditors in deciding whether an explanatory paragraph should be added to their reports.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[3] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the

[3] See footnotes 1 and 2 in paragraph 8.03.

results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note XX to the financial statements, [*State of domicile's insurance regulatory body*] imposes risk-based capital requirements on insurance entities, including the Company. At December 31, 20X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of domicile's insurance regulatory body*].

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

Uncertainties

8.05 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive audit evidence concerning its outcome would be expected to become available. Uncertainties include but are not limited to contingencies covered by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*, and matters related to estimates and other matters covered by FASB ASC 275-10-50.

8.06 Conclusive audit evidence concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related audit evidence are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. An audit includes an assessment of whether the audit evidence is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the audit evidence supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is or should be available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient audit evidence supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

8.07 If the auditor is unable to obtain sufficient audit evidence to support management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider expressing a qualified opinion or disclaiming an opinion because of a scope limitation. A qualified opinion or disclaimer of opinion because of a scope limitation is appropriate if sufficient audit evidence related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

8.08 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated attributable to departures from GAAP related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates.

8.09 *Inadequate disclosure*. If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP or statutory accounting practices (SAP), the auditor should express a qualified or an adverse opinion.

8.10 The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to the auditor's evaluation of the materiality of known and likely misstatements in the financial statements.

8.11 *Inappropriate accounting principles*. In preparing financial statements, management estimates the outcome of certain kinds of future events. Paragraphs 10–11 of FASB ASC 310-10-35 and paragraph 6 of FASB ASC 460-10-25 describe situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion.

8.12 *Unreasonable accounting estimates*. Usually, the auditor is able to obtain satisfaction regarding the reasonableness of management's estimate of the effects of future events by considering various kinds of audit evidence, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable and that its effect is to cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion.

Going Concern

8.13 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), establishes requirements and guidance on the auditor's responsibility for evaluating whether substantial doubt exists concerning the ability of the entity being audited to continue as a going concern for a reasonable period of time. Chapter 2, "Audit Considerations," describes going concern considerations as they relate to property and liability insurance entities and discusses how an insurance entity's regulatory capital position affects the auditor's assessment of whether there is substantial doubt about the insurance entity's ability to continue as a going concern. AU section 341 establishes requirements and guidance on going concern consideration audit documentation that is discussed in paragraphs 2.134–.136 of this guide. If the auditor concludes that there is substantial doubt about an insurance entity's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph) to express that conclusion or disclaim an opinion. (See paragraph 8.14 of this guide.) The auditor's conclusion about the insurance entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about the insurance entity's ability to continue as a going concern," or similar wording that includes the terms substantial doubt and going concern. The following is an illustration of an auditor's report (unqualified opinion) on the GAAP financial statements of an insurance entity that includes an explanatory paragraph because of the existence of substantial doubt about the insurance entity's ability to continue as a going concern for a reasonable period of time. The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. A similar paragraph could be adapted for use in an opinion on statutory-basis financial statements. They are not intended to provide criteria or other guidelines for the auditor to use in deciding whether an explanatory paragraph is necessary in their reports.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[4] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that ABC Property and Liability Company will continue as a going concern. As discussed in Note XX to the financial statements, [*State of domicile's insurance regulatory body*] imposes risk-based capital requirements on insurance entities, including the Company. At December 31, 20X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of domicile's insurance regulatory body*]. The Company has filed

[4] See footnotes 1 and 2 in paragraph 8.03.

a comprehensive financial plan with the commissioner outlining the Company's plans for attaining the required levels of regulatory capital by December 31, 20XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Property and Liability Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

8.14 Footnote 4 in paragraph .12 of AU section 341 states that the inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report (as described in paragraph 8.13) serves adequately to inform users of the financial statements of the auditor's substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Nonetheless, AU section 341 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's report containing a disclaimer of opinion as the result of uncertainties relating to an auditor's substantial doubt about an insurance entity's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We were engaged to audit the accompanying balance sheet of ABC Property and Liability Insurance Company as of December 31, 20X2, and the related statements of income, changes in stockholders' equity, other comprehensive income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management.

The accompanying financial statements have been prepared assuming that ABC Property and Liability Company will continue as a going concern. As discussed in Note XX to the financial statements, [*State of domicile's insurance regulatory body*] imposes risk-based capital requirements on insurance entities, including the Company. At December 31, 20X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by

[*State of domicile's insurance regulatory body*]. The Company has filed a comprehensive financial plan with the commissioner outlining its plans for attaining the required levels of regulatory capital by December 31, 20XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Property and Liability Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 20X2.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

Evaluating Consistency of Financial Statements

8.15 In January 2008, the PCAOB adopted Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), and related conforming amendments, which became effective November 15, 2008. This standard and its related amendments, among other significant provisions, update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with FASB ASC 250, *Accounting Changes and Error Corrections*. This standard also requires the auditor to recognize, in the auditor's report, an entity's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. This standard also clarifies that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement.

8.16 In the conforming amendments, the PCAOB removed the GAAP hierarchy from its standards because it believes the hierarchy is more appropriately located in the accounting standards. These amendments do not change the principles in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), for evaluating fair presentation of the financial statements in conformity with GAAP. This action was prompted by and issued concurrently with FASB's issuance of FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which also became effective November 15, 2008.* The Auditing Standards Board will coordinate the provisions and effective date of its associated exposure draft, *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*, with the effective date of the FASB statement.

Qualified Opinion

8.17 Paragraph .20 of AU section 508 (AICPA, *Professional Standards*, vol. 1) describes certain circumstances where the auditor may qualify the opinion on the financial statements. A qualified opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is issued under the following circumstances:

a. There is a lack of sufficient appropriate audit evidence or there are restrictions on the scope of the audit that have led the auditor to conclude that an unqualified opinion cannot be expressed and the auditor has concluded not to disclaim an opinion.

b. The auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

Disclaimer of Opinion

8.18 Paragraphs .61–.63 of AU section 508 (AICPA, *Professional Standards*, vol. 1) establish requirements and guidance regarding disclaimers of opinion. A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with GAAP. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer. A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statements. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from GAAP.

8.19 When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. The opinion should state that the scope of the audit was not sufficient to warrant the expression of an opinion. In addition, the report should disclose any other reservations the auditor has regarding fair presentation in conformity with GAAP. The auditor should not identify the procedures

* On June 30, 2009, the Financial Accounting Standards Board (FASB) released Accounting Standards Update No. 2009-01, *Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168*—The *FASB Accounting Standards Codification*™ and the Hierarchy of Generally Accepted Accounting Principles.

The objective of this statement is to replace FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, and to establish the FASB *Accounting Standards Codification*™ as the source of authoritative accounting principles recognized by FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.

that were performed or include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer.

Adverse Opinion

8.20 Paragraphs .58–.60 of AU section 508 (AICPA, *Professional Standards*, vol. 1) establish requirements and guidance regarding adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed if, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When expressing an adverse opinion, the auditor should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. If an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting

8.21 Paragraph .01 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states when performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor may choose to issue a combined report or separate reports on the entity's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of PCAOB Auditing Standard No. 5, and appendix C, "Special Reporting Situations," for direction about reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of PCAOB Auditing Standard No. 5, which includes an illustrative combined audit report.

If the auditor issues separate reports on the entity's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the entity's financial statements:

> We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20XX, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor's report on the entity's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraph 89 of PCAOB Auditing Standard No. 5 for direction about the report date in an audit of internal control over financial reporting.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

8.22 PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes requirements and provides directions for auditors engaged to report on whether a previously reported material weakness in internal control over financial reporting continues to exist as of a date specified by management. The engagement described by the standard is voluntary and the standards of the PCAOB do not require an auditor to undertake an engagement to report on whether a previously reported material weakness continues to exist.

Auditors' Reports on Statutory Financial Statements of Insurance Entities

8.23 All states require domiciled insurance entities to submit to the state insurance commissioner an Annual Statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the Annual Statements. Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the regulatory authority of the state of domicile," referred to in this Audit and Accounting Guide as SAP. SAP are considered an other comprehensive basis of accounting as described in AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1).

NAIC-Codified Statutory Accounting

8.24 NAIC codified SAP for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the manual). The insurance laws and regulations of the states require insurance entities domiciled in those states to comply with the guidance provided in the NAIC manual except as prescribed or permitted by state law.

8.25 Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the manual in whole or in part as an element of prescribed SAP in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed SAP applicable in each state.

8.26 Permitted SAP include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the state prescribed SAP or (*b*) if prescribed SAP do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from entity to entity within a state, and may change in the future. In instances where the domiciliary state regulator is considering approval of a request for an accounting practice that departs from the NAIC manual and state prescribed accounting practices, the domiciliary regulator must provide notice under the requirements as defined in paragraphs 55–56 of the Preamble. See paragraphs 1.75–.80 of this guide for additional information.

General Use Reports

8.27 Paragraph .04 of AU section 544, *Lack of Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1), states that the auditor should use the standard form of report described in AU section 508 (AICPA, *Professional Standards*, vol. 1), modified as appropriate because of the departures from GAAP, if an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities to whose jurisdiction the insurance entity is subject.

8.28 Interpretation No. 15, "Auditor Reports on Regulatory Accounting or Presentation When the Regulatory Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," of AU section 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .96–.98), affirms the specifics of paragraph .05*f* of AU section 623 and AU section 544. Interpretation No. 15 states that the auditor is precluded from using the form of the report set forth in AU section 623 "in circumstances in which the entity distributes the financial statements to parties other than the regulatory agency either voluntarily or upon specific request." Paragraph .04 of AU section 544 states that in those circumstances (referring to circumstances in which the financial statements and reports will be used by parties or distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject) the auditor should use the standard form of report modified as appropriate because of the departures from GAAP, and then, in an additional paragraph express an opinion on whether the financial statements are presented in conformity with the regulatory basis of accounting. See paragraph 8.30 of this guide for a report sample.

8.29 Although it may not be practicable to determine the amount of difference between GAAP and SAP, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance entities' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and SAP are material and pervasive. The auditor should express an adverse opinion when, in the auditor's judgment, the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. The auditor may determine that the differences between GAAP and SAP are not material and pervasive.

8.30 The auditor, when expressing an adverse opinion, should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (*a*) all of the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[5] If the effects are

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[5] AU section 431, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*, vol. 1), defines practicable as ". . . the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor

(continued)

not reasonably determinable, the report should so state and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss SAP and describe how those practices differ from GAAP.

8.31 After expressing an opinion on the statutory financial statements as to conformity with GAAP, auditors may also be requested to express an opinion on whether the statutory financial statements are presented in conformity with SAP. If departures from SAP are found to exist and are considered to be material, auditors express a qualified or adverse opinion on the statutory financial statements just as they would under AU section 508 (AICPA, *Professional Standards*, vol. 1) regarding conformity with GAAP.

8.32 Following is an illustration of an independent auditor's report on the general-use financial statements of an insurance enterprise prepared in conformity with SAP, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with SAP. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and the SAP are not reasonably determinable.

Independent Auditor's Report

To the Board of Directors
ABC Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[6] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*State of domicile*], which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between these statutory accounting practices and accounting principles generally accepted in the

(footnote continued)

to assume the position of a preparer of financial information." For example, information is presented in the auditor's report if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit.

[6] See footnotes 1 and 2 in paragraph 8.03.

United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows[7] for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

The financial statements are not prepared solely for filing with a regulatory agency. However, paragraph .98 of Interpretation No. 15 of AU section 623 states that if the auditor issues a report in accordance with AU section 623 paragraph .05*f*, nothing precludes the auditor, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

Limited Use Reports

8.33 Prescribed-or-permitted SAP for insurance enterprises are considered an other comprehensive bases of accounting as described in paragraph .04 of AU section 623. If an insurance entity's statutory financial statements are intended solely for filing with state regulatory authorities to whose jurisdiction the insurance entity is subject, paragraph .05 of AU section 623 states that the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP and such reporting is appropriate even though the auditor's report may be made a matter of public record. However, that paragraph further states that limited use reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance entity is subject. The auditor's report should contain a statement that there is a restriction on the use of the statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities to whose jurisdiction the enterprise is subject.

8.34 Although auditing standards do not prohibit an auditor from issuing limited use and general use reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance entities that do not prepare financial statements

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[7] Reference to cash flows would not be needed if the entity, under GAAP, is not required to present a statement of cash flows.

in conformity with GAAP will be able to fulfill all of their reporting obligations with limited use statutory financial statements.

8.35 Following is an illustration, adapted from paragraph .08 of AU section 623, of an unqualified auditor's report on limited use financial statements prepared in conformity with SAP.

Independent Auditor's Report

To the Board of Directors
ABC Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[8] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [*State of domicile*], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and the management of ABC Property and Liability Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

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[8] See footnotes 1 and 2 in paragraph 8.03.

General Use and Limited Use Reports

8.36 The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses SAP and describes how this basis differs from GAAP. In general use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited use statutory financial statements, the effects of the differences need not be quantified or disclosed.

8.37 The auditor may add an explanatory paragraph (or other explanatory language) under the circumstances described in paragraph .11 of AU section 508 (AICPA, *Professional Standards*, vol. 1) and paragraph .31 of AU section 623 regardless of any of the following:

a. The type of report—general use or limited use

b. The opinion expressed—unqualified, qualified, or adverse

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the SAP

For example, in a general use report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the SAP, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance entity's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

8.38 The auditor may emphasize a matter in a separate paragraph of the auditor's report. When an insurance entity prepares its financial statements using accounting practices prescribed or permitted by the regulatory authority of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance entity's statutory capital, the auditor may include an emphasis-of-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

8.39 An example of an emphasis-of-matter paragraph follows:

> As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [*State of domicile*] in 20XX to write up its home office property to appraised value; under prescribed statutory accounting practices, home office property is carried at depreciated cost. As of December 31, 20X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

8.40 If subsequent to the initial adoption of the revised manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the entity's financial statements, the auditor should refer to the change in an explanatory paragraph of the report. The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the SAP.

8.41 An example of an explanatory paragraph follows:

> As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

Special Reports

8.42 In connection with regulatory requirements, states have required the filing of special reports, such as those on loss reserves and internal control. In addition, independent auditors may provide other services in connection with regulatory requirements, such as NAIC examinations, or other services, to comply with state regulations. Special reports such as that illustrated in exhibit 8-1 may also apply in other circumstances. Certain regulatory authorities may request opinions on loss reserves in connection with licensing applications or other planned transactions. For example, an insurance entity holding a certificate of authority as surety on federal bonds may be required to submit to the U.S. Treasury Department a report by an independent auditor on its loss reserves.

Special Reports on Loss Reserves

8.43 Exhibit 8-1 illustrates an auditor's report expressing an opinion on a entity's liabilities for unpaid losses and loss-adjustment expenses and the schedule of liabilities for unpaid losses and loss-adjustment expenses that would accompany the report.

8.44 The procedures performed to issue an opinion on the liabilities for unpaid losses and loss-adjustment expenses may be more extensive than those for testing those accounts as part of an audit of the basic financial statements. Any such additional procedures may be completed in conjunction with the general audit. Accordingly, an opinion on the liabilities for unpaid losses and loss-adjustment expenses ordinarily should have the same date as the report on the basic financial statements.

8.45 Because of the nature and significance of the liabilities for unpaid losses and loss-adjustment expenses in an insurance entity, the form of opinion that is expressed on the liabilities for unpaid losses and loss-adjustment expenses should be consistent with the opinion expressed on the audited financial statements. For example, if the report on the liabilities for unpaid losses and loss-adjustment expenses was qualified, the report on the audited financial statements should also be qualified.

8.46 Changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss-adjustment expenses accompanying the auditor's special report. (See Auditing Standards Board Opinion No. 20, *Accounting Changes*, paragraph 33.)

Exhibit 8-1

Special Report on Loss Reserves[9]

Independent Auditor's Report

Board of Directors
X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Conduct to undertake only those engagements which we can complete with professional competence.

We have audited the financial statements prepared in conformity with accounting principles generally accepted in the United States of America [or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ___________] of X Insurance Company as of December 31, 20X0, and have issued our report thereon dated March 1, 20X1. In the course of our audit, we have audited the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 20X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly, in all material respects, the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 20X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ___________ on a basis consistent with that of the preceding year.

This report is intended solely for the information and use of regulatory agencies and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

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[9] If a significant period of time has elapsed between the date of the report on the financial statements and the date the auditor is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph after the opinion paragraph: "Because we have not audited any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 20X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our audit."

X Insurance Company
Schedule of Liabilities for Losses
and Loss Adjustment Expenses
December 31, 20X0

Liability for losses	$XX,XXX,XXX
Liability for loss-adjustment expenses	X,XXX,XXX
Total	$XX,XXX,XXX

Note 1—Basis of presentation

The schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of __________ . [*Significant differences between statutory practices and generally accepted accounting principles for the calculation of the amounts should be described but the monetary effect of any such differences need not be stated*.]

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [*and/or regulations*] of the State of __________. Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

Note 2—Reinsurance

The company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by $XXX,XXX and $XXX,XXX, respectively, for reinsurance ceded to other companies. Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the company under existing reinsurance agreements.

Appendix A

Additional Audit Considerations for Loss Reserves, Premiums, Claims, and Investments

Audit Objectives

AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), states that the auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate audit evidence to provide reasonable assurance that

a. all accounting estimates that could be material to the financial statements have been developed.

b. those accounting estimates are reasonable in the circumstances.

c. the accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

When performing an integrated audit, in evaluating reasonableness of an estimate, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate (paragraph .10 of AU section 342).

When auditing a property/liability insurance entity, the auditor is primarily concerned with obtaining sufficient appropriate audit evidence to support the assertions inherent in an entity's financial statements. AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), defines relevant assertions and discusses their use in assessing risks and designing appropriate further audit procedures.

Understanding Loss Reserves

As discussed in chapter 2, "Audit Considerations," AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol.1), requires auditors to obtain an understanding of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (*a*) to assess risks of material misstatement of the financial statements and (*b*) to design and perform further audit procedures (tests of controls and substantive tests). As part of obtaining and understanding of the insurance entity and its environment, the auditor should obtain a thorough understanding of the entity's overall operations including its claim reserving and payment practices.

The auditor performing or supervising the audit of loss reserves should have knowledge about loss reserving including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of the appropriate methods available for calculating loss reserves. Knowledge about loss reserving is ordinarily obtained through experience, training courses, and by consulting sources such as industry publications, textbooks, periodicals, and individuals knowledgeable about loss reserving. As stated in chapter 4 of this guide, if the auditor is not a loss reserve specialist, he or she should use the work of an outside loss reserve specialist in the audit. The auditor should obtain a level of knowledge about loss reserving that would enable him or her to understand the methods or assumptions used by the specialist.

Ordinarily, audit procedures performed to obtain sufficient evidence to support assertions about loss reserves are time consuming and may be performed most efficiently when initiated early in the fieldwork.

The auditor should determine that all loss reserve components, all lines of business, and all accident years that could be material to the financial statements have been considered in developing the overall reserve estimate. The components of loss reserves are described in chapter 4 of this guide.

The estimate of loss reserves will frequently affect other accounting estimates contained in the financial statements. The auditor should evaluate accounting estimates for such items as contingent commissions, retrospective premium adjustments, policyholder dividends, recoverability of deferred acquisition costs, premium deficiencies, state assessments based on losses paid, minimum statutory reserves, and the liability or allowance for unauthorized or uncollectible reinsurance.

Audit Risk and Materiality

Audit risk and materiality, among other matters, need to be considered together in designing the nature, timing, and extent of audit procedures to be performed and in evaluating the results of those procedures. The auditor should determine a materiality level for the financial statement taken as a whole when establishing the overall audit strategy for the audit. For most insurance entities, the largest liability on the balance sheet is loss reserves, and the largest expense on the income statement is incurred losses; therefore, both are material to the financial statements. In addition, loss reserve estimates are based on subjective judgments and, therefore, involve a high level of inherent risk. For these reasons, loss reserves typically are the area with the highest risk of material misstatement in a property and liability insurance entity.

AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on the auditor's consideration of audit risk and materiality when performing an audit of financial statements in accordance with generally accepted auditing standards. When performing an integrated audit, refer to paragraph 20 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding materiality and planning considerations, respectively. AU section 312 clarifies that auditors should include both qualitative and quantitative considerations when evaluating misstatements and specifies the importance of individual and aggregate misstatement analysis. Materiality judgments are made in light of surrounding circumstances and the auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of the financial statements.

Some factors to be considered in establishing materiality levels for estimates such as loss reserves are the entity's operating results and the entity's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions.

Once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited. Materiality is determined based on the auditor's understanding of the user needs and expectations. User expectations may differ based on the degree of inherent uncertainty associated with the measurement of particular items in the financial statements, among other considerations. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (for example, provisions for insurance claims in the case of an insurance entity) may influence the user's assessment of materiality. However, for audit purposes, this factor does not cause the auditor to follow different procedures for planning or evaluating misstatements than those outlined for other entities.

AU section 312 states that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by error or fraud, are detected. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1),[1] provides specific guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. Chapter 2, "Audit Considerations," contains a detailed discussion of AU section 316 (AICPA, *Professional Standards*, vol. 1). Additionally, when performing an integrated audit, refer to paragraph 9 of Auditing Standard No. 5 regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

As discussed in chapter 2, audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect. At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk:

a. *The risk of material misstatement* is the auditor's combined assessment of inherent risk and control risk; however, the auditor may make separate assessments of inherent risk and control risk. Inherent risk and control risk are the entity's risks, that is, they exist independently of the audit of financial statements. The assessment of the risk of material misstatement at the assertion level is a judgment rather than a precise measurement of risk; however, the auditor should have an appropriate basis for that assessment.

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[1] The AICPA Practice Aid *Fraud Detection in a GAAS Audit—Revised Edition* assists auditors in understanding the requirements of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), and whether current audit practices effectively incorporate these requirements.

This basis may be obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, including its internal control, and through the performance of suitable tests of controls to obtain audit evidence about the operating effectiveness of controls, where appropriate.

i. *Inherent risk* is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures than for others. In addition to those circumstances that are peculiar to a specific relevant assertion, factors in the entity and its environment that relate to several or all of the account balances, classes of transaction, or disclosure may influence the inherent risk related to a specific relevant assertion. Loss reserves generally are based on subjective judgments about the occurrence of certain events that have not yet been fully reported, developing trends, and the outcome of future events. Due to the subjectivity and inherent imprecision involved in making such judgments, estimating loss reserves requires considerable analytical ability and an extensive understanding of the business.

ii. *Control risk* is the risk that a material misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal controls. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control. The degree of control risk associated with significant accounting estimates is usually greater than the risk for other accounting processes because accounting estimates involve a greater degree of subjectivity, are less susceptible to control, and are more subject to management influence. It is difficult to establish controls over errors in assumptions or estimates of the future outcome of events in the same way that controls can be established over the routine accounting for completed transactions. In addition, there is a potential for management to be biased about their assumptions; accordingly, a high level of professional skepticism should be exercised by the auditor. The likelihood that loss reserve estimates will contain misstatements of audit importance can be reduced by using competent people in the estimation process and by implementing practices to enhance the reasonableness of estimates, such as requiring that persons making the estimates retain documented explanations and other support for assumptions and methodologies used, and perform retrospective tests of past performance.

b. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors might be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, supervision and review of the audit work performed, and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Due to the relatively high inherent and control risk associated with loss reserves, detection risk is significant in the audit of loss reserves but may be mitigated by adequate planning, supervision, and conduct of the audit. Adequate planning should identify the existing inherent and control risk factors so that they may be adequately addressed in the audit.

This appendix identifies some of the matters that may influence audit risk in an audit of the financial statements of a property and liability insurance entity. It emphasizes matters relevant to the premium cycle, the claims cycle, and the investment cycle.

Premium Cycle

- *Premiums*
  - — Principal lines of business written (property or liability, commercial or personal, and so on)
  - — Geographic, product, or other concentrations
  - — Rate-making environment and policies or practices
  - — Changes in product mix or emphasis
  - — Extent of retrospectively rated or reporting-form business and the estimability and timeliness of retrospective revenue or expense determinations
  - — Unusual, erratic, or substantial changes in premiums in force
  - — Propriety of premium revenue-recognition methods used
  - — Evidence or expectations of increased competition, market saturation, or declining demand
  - — Significant accounting procedures performed at other locations, such as branch offices versus the home office
  - — Principles and policies used by the entity in recognition of premiums
  - — Statistical coding system used to support underwriting functions

- *Receivables*

  — Suspense-account activity and condition (for example, large or old uncleared items or numerous outstanding debt and credit items)

  — Agent statement terms and financing arrangements (for example, extended credit terms, expense supplements, loans, and profit-sharing arrangements)

  — Agency concentration (for example, significant volume from limited numbers of agents)

  — Agency profitability (for example, derivation of substantial unprofitable business from particular agents)

  — Nonadmitted asset trends (for example, sizable past-due or uncleared balances)

  — Commission arrangements (for example, contingent commissions, or unusual commission structures that may encourage agent fraud)

  — Agent-binding authorities to accept underwriting risks or settle claims without prior approval

  — Agent commingling of insurer/insured funds collected in a fiduciary capacity (for example, use of third-party funds for operating or personal purposes)

  — Reasonableness of estimates for earned but unbilled premiums

  — Adequacy of premium installment payments to provide sufficient protection in the event of policy cancellation

- *Deferred policy-acquisition costs*

  — Nature of costs deferred, particularly those that vary indirectly with new business written

  — Frequency and adequacy of recoverability (premium deficiency) tests, particularly regarding line of business groupings and estimated loss-ratio projections

- *Reinsurance*

  — Changes in risk-retention levels, including catastrophic loss coverage

  — Financial responsibility, and stability of ceding or assuming reinsurers, intermediaries, "fronting" entities, pools and syndicates, and so on

  — Reliability, adequacy, and timeliness of financial reporting, particularly in the case of reinsurance assumed

  — Business purpose of the reinsurance transactions

Loss Reserves and Claims Cycle[2]

- An entity's product mix may have a significant effect on the variability of loss reserves. It is more difficult to estimate loss reserves for long-tail lines of business than it is to estimate reserves for short-tail lines of business because events affecting ultimate claim settlement amounts will occur at a later date.
- New products or new types of risks generally will add to the subjectivity of the loss reserving process because of the entity's lack of experience with the new product and relative lack of relevant historical data.
- Deductibles, policy limits, and the retention level of specific lines of business may have a significant effect on the volatility of losses to be settled.
- Policy lines with a low frequency and high severity of claim settlements may exhibit more variability than policy lines associated with a high frequency and low severity of claim settlements.
- Future inflation may result in ultimate loss settlements different from the amounts originally anticipated.
- Social inflation, which arises from the legal environment, as well as recent jury awards have the potential to increase ultimate loss settlements.
- The level and consistency of backlogs in processing claims affect the stability of loss reserve analyses.
- The degree of management's optimism or skepticism when establishing loss reserve assumptions may lead to fluctuations in reserves.
- The introduction of new policy forms may result in an unanticipated expansion of coverage. In addition, the entity may lack historical data for losses under the new policy forms.
- Changes in regulations may cause insurance entities to change their claims adjusting practices; for example, a change in regulations may require an increase in the waiting period before workers' compensation benefits begin, or "bad faith" claim settlement laws may alter settlement practices.
- Catastrophic or unusual losses may distort historical experience. Reserves for catastrophic losses, particularly losses that occur near the end of the period, are difficult to estimate.
- Insurance entity cash flow considerations may result in a change in loss payment practices.
- The quality and experience of personnel reviewing an entity's loss reserves affect the overall control environment. For example, an entity that employs a qualified actuary or an experienced loss reserve specialist to review reserves is usually better equipped to estimate loss reserves than is an entity that uses a less qualified individual to perform that task.

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[2] See the "Auditing Loss Reserves" section of chapter 4, "The Loss Reserving and Claims Cycle," for National Association of Insurance Commissioners management, auditor, and actuarial coordination requirements and potential scope expansion in the area of actuarial data integrity.

- The proper functioning of controls over claim processing will reduce the possibility of error in the data underlying loss reserve estimates. The risk of error in the claims data base will be minimized if controls are functioning as designed.
- The completeness and accuracy of an entity's data base will affect the risks of misstatement in assertions about loss reserves.
- The accuracy and reliability of claims data received from outside sources (that is, cedents, reinsurers, and voluntary and involuntary risk pools) will also affect the risks of misstatement in assertions about loss reserves.
- The adequacy of information and data produced by an entity is critical in projecting loss reserves. For example, an entity capable of accumulating only basic data on premium and loss experience generally poses a greater risk, all other things being equal, than does an entity that is capable of accumulating and analyzing more sophisticated data.
- Significant decentralization of operations and reliance on intermediaries may increase control risk.
- A high level of delegation of claims processing or adjusting functions to intermediaries or outside adjusters, without adequate supervision, may result in inefficient claim handling and inappropriate case reserve estimates.
- Changes in delegated responsibilities may result in changes in claims settlement patterns and thereby invalidate historical claim experience.
- The quality of an entity's underwriting and claims staff and its knowledge of the industry and control over the entity's exposure to loss will have a significant effect on the loss reserving process.
- Existing manual or computerized systems may not be able to cope with a change in the volume of claims.
- Changes in the insurance entity's claims processing system may invalidate the historical data used to develop and evaluate loss reserves. Types of changes that may have this result include
  - — changes in claim classification, such as counting claimants instead of counting claims, considering reopened claims as incurred but not reported claims rather than as development on reported claims, and changing the definition of claims closed without payment.
  - — changes in settlement patterns, such as slowing down the payment of claims to increase the holding period of investable assets or speeding up the payment of claims to decrease the effects of inflation.
  - — changes in case reserving methodologies, either explicit or implicit, such as a change from estimating case basis reserves on an ultimate cost basis to estimating case-basis reserves on a current cost basis.
  - — changes in computerized information systems that result in faster or slower recognition and payment of claims.

Investment Cycle

- Significant concentrations of credit risk with one counterparty or within one geographic area
- Significant use of derivative securities particularly without relevant in-house expertise
- High volumes of borrowing or lending of securities
- Relatively high volatility in interest rates
- Changes in the terms of government guarantees
- Actual prepayment experience that differs significantly from that anticipated
- Declines in the values of collateral underlying securities
- Changes in guarantor's claims processing
- Significant conversion options related to the collateral (for example, variable to fixed rates)
- Sales and transfers from the held-to-maturity securities portfolio
- High volume of transactions in the available-for-sale or trading securities portfolios
- Wash sale transactions
- Uncertainty regarding the financial stability of asset-backed securities services or of guarantors
- Investment liquidity (for example, investments with terms and maturities not balanced to meet policy claim obligations)
- Investment valuation (for example, improper or inadequate valuation methods or documentation and indications of potential or likely permanent impairment)
- Investment yield trends (that is, the indicated ability to manage the investment portfolio at maximum yields commensurate with prudent risk considerations)
- Investment policy (for example, undue emphasis in speculative or high-risk investment vehicles)
- Investment restrictions (that is, degree of compliance with regulatory or self-imposed restrictions)

Acquisition Costs

- Deferral of costs that vary with and are primarily related to the production of new and renewal business
- Capitalized acquisition costs appropriately amortized in relation to premiums earned
- Capitalized costs should be recoverable in relation to anticipated loss experience, anticipated earned premiums, and other factors
- The entity's accounting policy for acquisition costs consistently applied

Other

- Adequacy of premium and claim cutoff procedures at interim and annual reporting dates
- Accuracy and thoroughness of statistical coding system used for underwriting (premium, loss, and expense) analysis
- Timeliness and adequacy of reconciliation procedures, particularly in balancing accounting and statistical records, including loss-development data
- Industry experience of principal officers and employees
- Statutory compliance and solvency
- Existence and extent of related-party transactions

Appendix B

Illustrations of Auditing Objectives and Procedures

As discussed in chapter 2, "Audit Considerations," paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in conformity with generally accepted accounting principles, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

a. Assertions about classes of transactions and events for the period under audit:

   i. *Occurrence.* Transactions and events that have been recorded have occurred and pertain to the entity.

   ii. *Completeness.* All transactions and events that should have been recorded have been recorded.

   iii. *Accuracy.* Amounts and other data relating to recorded transactions and events have been recorded appropriately.

   iv. *Cutoff.* Transactions and events have been recorded in the correct accounting period.

   v. *Classification.* Transactions and events have been recorded in the proper accounts.

b. Assertions about account balances at the period end:

   i. *Existence.* Assets, liabilities, and equity interests exist.

   ii. *Rights and obligations.* The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

   iii. *Completeness.* All assets, liabilities, and equity interests that should have been recorded have been recorded.

   iv. *Valuation and allocation.* Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

c. Assertions about presentation and disclosure:

   i. *Occurrence and rights and obligations.* Disclosed events and transactions have occurred and pertain to the entity.

   ii. *Completeness.* All disclosures that should have been included in the financial statements have been included.

   iii. *Classification and understandability.* Financial information is appropriately presented and described and disclosures are clearly expressed.

   iv. *Accuracy and valuation.* Financial and other information are disclosed fairly and at appropriate amounts.

Substantive procedures are performed to detect material misstatements at the relevant assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. As described in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), the auditor should plan and should perform substantive procedures to be responsive to the related planned level of detection risk, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations in internal control, including the risk of management override, the possibility of human error, and the effect of systems changes. Therefore, regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence.

The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement. Because of the large volume of transactions in the premium and claims cycle, audit sampling techniques—either statistical or nonstatistical—are often employed in applying certain tests.

Note that in an integrated audit, the practitioner should refer to paragraphs 28–33 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for a discussion of identifying relevant financial statement assertions. See the applicable PCAOB standards and related rules and chapters 2 and 4, "The Loss Reserving and Claims Cycle," for additional guidance.

These illustrations are not intended to be all-inclusive. The auditor should plan and perform substantive procedures to be responsive to the related assessment of the risks of material misstatement. More detailed auditing issues and procedures are discussed in specific chapters of this guide.

Exhibit B-1

Premium Cycle

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Existence	● Premiums, commissions, and revenue and expense amounts recorded must relate to policies issued or in force during the period.	● Unissued policy forms are physically controlled. ● Policy applications are properly registered.	● Obtain evidence about proper issuance by — checking policy file for signed application and underwriting approval. — tracing to master file data such as policy number, name, effective date, kind of policy, coverage limits, premium, payment mode, and agent. — comparing premiums to cash receipts records. ● Check daily reports for underwriting approval, calculation of premiums and commissions, and proper recording of premium payments. ● Reconcile premiums and commissions to agents' reports. ● Trace selected premiums transactions to premium register to check that policy terms, lines of business, and premium amounts have been properly recorded. ● Reconcile monthly summary of premiums written direct, assumed, and ceded and related commission with general ledger. ● Test that agents submitting applications are licensed, and inspect agency agreements.

(*continued*)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Completeness	● Premium amounts include premiums from all policies and are accurately compiled.	● Policies are recorded on a timely basis in the detail policy records, and records are reviewed for recording of all policy numbers. ● Guidelines are established for coding policies, and coding is reviewed for accuracy. ● Input, output, and data center controls are maintained to ensure that all changes to detail policy records are processed properly.	● Test that premiums are recorded as described previously. ● Assess control over policy forms and policy issuance by — testing whether policies supplied to agents are promptly entered on policy control records. — inspecting policy numbers issued and testing procedures for investigation of missing numbers. — reconciling policy allotment register to underwriting reports of new business. — testing whether daily reports are recorded before filing. ● Check calculation of premiums to premium rate tables. ● Compare ratios of commissions to premiums written with ratios of prior years, and investigate significant fluctuations.
	● Agents' balances include all amounts due to or from agents as of balance sheet date.	● Amounts included in commission calculations are reconciled to premiums written. ● Detailed agent's accounts are reconciled to the general ledger.	● Test that premiums and commissions are recorded as described earlier. ● Trace selected commission rates to commission schedules.

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Rights and Obligations	● Return premiums, policy-holder dividends, and retroactive premium adjustments are properly recorded.	● Policy endorsements and cancellations or other changes are approved; determinations of additional or return premiums are also reviewed. ● Policyholder dividends, retrospective premiums, and experience-rated premiums are reviewed and approved. ● Premium adjustments are compared with policy provisions, and dividends are compared with dividend declaration for compliance.	● Test the propriety of return premiums by inspecting evidence of cancellation on policy face and by obtaining evidence about adherence to entity policy regarding cancellation method. ● Test that policyholder dividends comply with authorization, and reconcile amounts with underlying policy records. ● Inspect transactions on periodic reporting policies to test whether periodic reports are received according to terms of policies, audits required by policies are performed, and premium deposits and additional or return premiums are properly calculated and recorded. ● Inspect premiums recorded for retrospectively rated policies to test whether entity procedures and policy terms have been followed in determining premiums and whether claims data have been included in the calculations.
		● Premium and loss data underlying calculations are reconciled to the records, and calculations are reviewed and approved.	

(*continued*)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
	● Reinsured policies are properly identified, and premiums on ceded reinsurance are properly recorded and reported to assuming entities.	● Risks covered by reinsurance agreements are identified, properly designated, recorded in the premium billing and in-force files, and reported to the assuming entity.	● Test whether risks in excess of retention amounts are reinsured. ● Test computation of reinsurance premiums and commissions; trace to reinsurance records. ● Trace information from premium records to reports sent to reinsurers. ● Test the propriety of reinsurance balances payable by reference to reinsurance agreements and policy records.
Valuation or Allocation	● Premium revenues and unearned premium reserve are recorded properly.	● Premium register is balanced periodically to update premiums in force. ● Premiums written are recorded in the general ledger and are reconciled periodically to premiums entered in statistical records and the premium register ● Return premiums are reviewed for reasonableness by comparison to original premiums.	● Inquire about the method for recognizing premium revenue and determining unearned premium reserves; check consistency of its application with prior years. ● Inspect recording of unearned premium reserves by reconciling additions and deletions in force for selected periods back to original documentation and by checking calculation of unearned premiums. ● Test that the unearned premium reserves are correctly reduced for ceded insurance.

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
	● Uncollectible agents' balances are identified and accounted for.	● Agents' balances are periodically aged in conformity with statutory requirements.	● Compare aged trial balance of agent's balances with similar trial balances of previous periods, and investigate significant fluctuations. ● Test collectibility by inspecting subsequent collections or by inspecting history of receipts. ● Evaluate the adequacy of the allowance for doubtful accounts, including suspense items.
		● Delinquent accounts are investigated and write-offs of bad debts and unreconciled items are approved. ● Advances to agents are approved in accordance with entity procedures. ● Statements of transactions and balances are periodically sent to agents.	● Test whether agents' balances considered to be nonadmitted assets were properly excluded from the statutory statements and included in the generally accepted accounting principles (U.S. GAAP) statements only to the extent deemed collectible.
	● Acquisition costs are properly capitalized and amortized.	● Deferrable costs are properly capitalized and amortized. ● Amortization of deferred costs is compared for consistency with premium recognition.	● Inspect documentation of procedures for recording acquisition costs. ● Inspect the support for deferred acquisition costs. ● Test whether acquisition costs are properly capitalized and amortized on a consistent basis. Also test whether the balance at year-end is reasonably expected to be recovered.

Claims Cycle[1]

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Existence or Occurrence	● Paid claims relate to transactions during the period, and unpaid claims are recorded as of the balance sheet date.	● Initial entry of claims data is appropriately controlled. ● Claims are checked against daily reports for existence of coverage. ● Proper documentation and proof of loss are obtained before payment. ● Salvage and subrogation are noted in claims files and are followed up. ● Supporting data for claims and compliance with entity policies are reviewed before approval of claim payments.	● For selected paid claims, inspect documentation of loss payments for approval and inspect canceled checks or drafts for proof of payments. ● Inspect documentation of selected paid claims supporting relevant accounting and statistical data, such as amounts, incurred dates, and coding. ● For selected unpaid claims (case-basis files), inspect documentation supporting relevant accounting data (such as amounts of reserves shown in the outstanding claims listing).
Completeness	● Records include all claims paid during the period and all reported claims unpaid as of the balance sheet date.	● Procedures are in effect to ensure that claims and related information are promptly reported to the claims department.	● Reconcile paid claims to the general ledger and appropriate subsidiary ledger and statistical records. ● Select open claims (including reopened claims) from the files and test whether they are properly accounted for on the outstanding claims listing.

[1] See the "Auditing Loss Reserves" section of chapter 4, "The Loss Reserving and Claims Cycle," for National Association of Insurance Commissioners management/auditor/actuarial coordination requirements and potential scope expansion in the area of actuarial data integrity.

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
		● Prenumbered claim files are used or sequential claim numbers are assigned. ● Appropriate controls of input, output, and other data are maintained to ensure that all claims are processed. ● Detailed control records are maintained for all reported claims.	● Reconcile unpaid claims (case basis) to the general ledger and appropriate subsidiary ledger and statistical records. Reconcile unpaid claim files to inventory. ● Test whether claim processing cutoff at balance sheet date was proper and consistent with prior year. ● From paid-loss transactions and the trial balance or master file of outstanding claims, test accumulation of data and balances by line of business and by accident or exposure period. ● For selected claim files closed without payment, test whether they have been properly closed.
		● Statistical data are periodically reconciled to detail records. ● Inventory of unpaid claims files is periodically reconciled to the master file for errors or omissions.	
Rights and Obligations	● Reserves and related balances under reinsurance assumed are properly recorded.	● Current information is maintained on the status of assumed and ceded reinsurance contracts ● For facultative reinsurance, reported claims are reviewed for notification of the reinsurer.	● Review abstracts of significant reinsurance agreements. ● Trace relevant accounting data to reports provided by ceding entities. ● For significant treaties or groupings of treaties, obtain or prepare a development of losses.

(*continued*)

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
		● For treaty reinsurance, reinsurance recoverable estimates are recorded on a reinsurance bordereau, which is forwarded to the reinsurer in accordance with contract terms.	● Evaluate whether the incurred but not reported (IBNR) reserve includes adequate provision of IBNR claims under reinsurance agreements.
	● Reinsurance recoverable on paid and unpaid losses is properly recorded.	● Reinsurance recoverable is regularly reconciled to detailed records. ● Claims are reviewed for applicability of reinsurance and the reinsurers are promptly notified. ● Reinsurers are promptly billed as claims are paid. ● Paid claims are accumulated for recoveries under excess contracts.	● Reconcile summary of reinsurance recoverable to general ledger. ● Confirm selected balances with reinsurers. ● Evaluate whether loss reserves have been properly reduced for reinsurance contracts. ● Trace relevant accounting data to reports provided to assuming entities. ● Review Schedule F, "Assumed and Ceded Reinsurance," of the annual statement, and investigate significant or unusual items.
	● Liability for outstanding drafts is properly recorded.		● Obtain a list of the unpaid drafts account as of the balance sheet date and reconcile to general ledger. ● On a test basis, trace draft payments subsequent to balance sheet date back to list. ● Agree prepaid drafts to paid drafts on a test basis, and test unpaid claims to list. ● Review supporting documents for material drafts that have been outstanding for an unreasonable length of time.

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Valuation or Allocation	● Paid losses and related accounts are recorded in the proper amounts. ● Estimates of loss reserves are reasonable.	● Outstanding loss reserves are balanced to monthly claims activity. ● Changes in outstanding loss reserves are promptly reviewed and recorded. ● For case-basis reserves, open claim files, including previous estimates of unpaid claims, are regularly reviewed and analyzed for adequacy of reserves in light of current information.	● Test posting of losses paid, loss-adjustment expenses paid, and reinsurance recoverable for claim selected from claim register; reconcile to subsidiary registers and statistical records. ● Reconcile the total amount of paid losses to cash disbursement records. ● Test loss-reserve development by line of business. ● Perform analytical procedures on losses incurred, losses paid, loss reserves, and loss ratios by line of business. ● Review current reports of state insurance examiners and loss developments prepared for the annual statements and Schedule P, and investigate significant items.
		● Appropriate officials regularly develop and analyze reserves for each line of business by accident year or by other appropriate basis. Development and analysis includes IBNR claims, claims adjustment expenses, and reserves on reinsurance assumed. ● Factors and assumptions used in estimating loss reserves are documented and periodically reviewed for reasonableness.	● Obtain evidence about the entity's method of determining the reserve for IBNR losses and evaluate its reasonableness. Determine if there have been any significant changes in the entity's methods and procedures, and evaluate the effect of all current trends and conditions. ● Compare current IBNR reserve against claims reported in subsequent period, and investigate significant fluctuations. ● Compare entity's IBNR loss-reserve development for prior periods with actual results, and investigate causes of significant discrepancies. ● Ensure the use of an actuary.

Investment Cycle[2]

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Existence	● Securities and investment assets included in the balance sheet physically exist.	● Transactions settled after year-end are reviewed for recording in the proper period (as of the trade date). ● Custodial function is independent of investment and accounting functions and provides security commensurate with the risks involved. ● Securities and evidence of ownership held by the entity are kept in vault with access limited to authorized personnel.	● Inspect and count the securities held on the client's premises as of the date that the securities amounts are reconciled to the general ledger control accounts. ● Obtain confirmations from the custodians of securities held for the client. Compare the confirmed lists with the trial balance and investigate discrepancies. ● Obtain confirmations that securities purchased under repurchase agreements but not delivered are being held by the sellers or the sellers' custodian on the entity's behalf. ● Confirm with brokers the status of securities in transit. ● Compare the face amounts or number of shares and the cost of investments recorded in the investment ledger with forms and documents created at the time of purchase. Examine forms and documents for proper completion and authorization.

[2] AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities. The companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing AU section 332. Practitioners should refer to AU section 332 and its companion audit guide for guidance on audit objectives, control activities and techniques, and auditing procedures. Additionally, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
		● Reports and confirmations of securities held by outside custodians are reconciled to entity records.	● Obtain and read custodial agreements and available reports regarding the adequacy of the custodians' internal controls and financial stability.
		● Financial responsibility and capability of outside custodians are periodically reviewed.	
Completeness	● Investment assets include all investments of the entity.	● Buy and sell orders to brokers are compared to brokers' advices.	● Inspect and count securities held by the client. Obtain confirmation from custodian of securities held for the account of the client.
	● Investment amounts include all transactions during the period.	● Authorized lists of signatures, brokers, and so forth are maintained.	● Read finance committee minutes and test whether investment transactions have been properly authorized.
			● Determine that only securities dealers approved by the finance committee are used.
		● Written policy statements detailing investment guidelines and limitations are prepared by designated levels of management.	● Compare investment yields during the period with expected yields based on previous results and current market trends; investigate significant discrepancies.
		● Potential investment transactions are reviewed by an investment advisory committee and approved by a finance committee.	● Test transactions settled after the end of the period for recording in the proper period (as of the trade date).
		● Questions concerning compliance with regulatory restrictions are referred to the legal department before transactions are executed.	● Review mortgages, real estate, leases, and other loans and investments for significant controlling interests.

(continued)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
		● New, current, and restructured transactions are reviewed for completeness.	
	● Investment records are properly compiled, and totals are properly included in the investment accounts.	● Recorded amounts of investments are periodically compared to safekeeping ledgers and to current market values.	● Examine input and output data and balances in individual investment accounts to test whether transactions are properly recorded. ● Compare investment totals to the client's reconciliation of the investment ledger to the general ledger control accounts. Investigate significant discrepancies and any large or unusual reconciling items.
		● Batch balancing, logging, and cash totals are used to provide assurance that all purchases and sales have been properly posted to master files.	
Rights and Obligations	● The entity has legal title or similar rights of ownership.	● Securities and other evidence of ownership are in the entity's name.	● Review legal department compliance records concerning statutory requirements and limitations. ● Examine securities to determine whether they are registered or payable to the entity, an authorized nominee, or the bearer. ● Examine bonds to determine whether interest coupons due after the count date are attached.

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Valuation or Allocation	● Investments are recorded at their proper amounts.	● Securities for which there is no active market are monitored for valuation at cost and are written down to market value when required. ● Interim securities valuations are obtained from outside brokers. ● Valuations for statutory reporting purposes are reviewed for conformity with National Association of Insurance Commissioners published values. ● Market prices for purchases and sales are compared with independent sources.	● Compare recorded costs of investments to published market quotations at trade date. Consider reasonableness of commission rates, taxes, and so on. ● Compare recorded market values of investments to published market quotations at the end of the period. ● Examine summaries of interest, dividend, and principal payments for indication of security value impairment. ● Examine past-due bonds and notes for endorsements or evidence of reductions in principal through receipt of partial payments.
	● Investment income and losses are recorded in the proper amounts.	● Unrealized gains and losses are substantiated by reconciliation with prior values. ● Adjustments of investment accounts are reviewed and approved by an authorized official.	● Test determination of interest earned, accrued interest receivable, and amortization of discount or premium. ● Test dividend income by reference to published dividend records. ● Test computations of realized gains and losses by appropriate cost method. ● Obtain financial reports of joint ventures or managed real estate and compare reported amounts of dividends, net rentals, and so on, to the records.

(*continued*)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
		● Interest and dividends are reviewed for accuracy by reference to reliable sources. ● Income amounts are compared to cash receipts records and are reconciled to the bond and stock master listings. ● Interest and dividends due but not received are reconciled to estimated and paid income lists.	● Review purchases and sales for indications of possible wash sales.
Presentation and Disclosure	● Investments are properly classified and disclosed.	● Realized capital gains and losses are properly recorded and classified. They are then submitted on a timely basis to the tax department.	● Test whether disclosures comply with U.S. GAAP. ● Inquire about pledging, assignment, or other restrictions. ● Read finance committee minutes. ● Examine loan agreements.

Appendix C

Illustrative Financial Statements and Disclosures

Note: The illustrative financial statements and footnote disclosures included in this guide have been updated to reflect Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC). However, in FASB's Notice to Constituents, it suggests the use of plain English in financial statement footnotes to describe broad FASB ASC topic references. They suggest a reference similar to "as required by the *Derivatives and Hedging* Topic of the FASB *Accounting Standards Codification*." Entities might consider revising their financial statement references to reflect this plain English referencing, rather than the use of specific FASB ASC references. We have provided these detailed references as a resource for our users.

Introduction

C.01 This appendix illustrates financial statements of a nonpublic property and liability insurance entity and the accompanying disclosures that are unique to such entities. Disclosures concerning the entity's pension plans, postretirement benefits other than pensions, stock options, lease commitments, long-term debt, extraordinary items, segments, accounting changes, derivative instruments, hedging activities, and other items that are not unique to property and liability insurance entities have been omitted for purposes of this guide. The format presented and the wording of the accompanying notes are only illustrative and are not necessarily the only possible presentations.

C.02 Except for the treatment of gains and losses described in FASB ASC 944, *Financial Services—Insurance*, for nontraditional insurance contracts, insurance entities that are Securities and Exchange Commission (SEC) registrants should follow Article 7 of SEC Regulation S-X, which prescribes the form and content of financial statements. Also, the SEC's Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, requires property and liability insurance entities to disclose in financial statements filed with the SEC certain information concerning reserves for unpaid claims and claim adjustment expenses. The Exchange Act requires certain supplementary information with respect to quarterly financial data. Other SEC regulations also require additional disclosures (for example, details with respect to deferred acquisition costs).

C.03 Governmental Accounting Standards Board (GASB) Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended and interpreted by various GASB pronouncements,[*]

[*] Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, provides guidance for the format and content of financial statements for all state and local governmental entities, including public entity risk pools.

requires public entity risk pools to present additional information beyond these illustrative financial statements. This additional information includes reporting assessments receivable from pool participants for premium deficiencies, disclosures about revenues collected in anticipation of future catastrophe losses, the aggregate outstanding amount of claims outstanding that have been settled through the purchase of annuity contracts, and the pool risk transfer agreement. Also, outstanding claims by kind of contract and 10-year claims development information on a policy-year basis should be presented as required supplementary information.

C.04 Interpretation No. 3, "The Impact on an Auditor's Report of Accounting Guidance Prior to its Effective Date," of AU section 410, *Adherence to Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 9410 par. .13–.18), addresses the impact on an auditor's report on a FASB statement prior to the statement's effective date. Readers may want to familiarize themselves with the guidance in that interpretation.

C.05 Also, preparers and auditors of SEC-registrant financial statements are reminded that as discussed in Staff Accounting Bulletin (SAB) Topic 11M (SAB 74), and Interpretation No. 3 of AU section 410, filings with the SEC that include financial statements for a period ending after the issuance of an accounting standard but before the required date of adoption of that accounting standard should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period. The following disclosures should be considered by registrants:

- A brief description of the new standard, the date that adoption is required, and the date that the registrant plans to adopt, if earlier;
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined;
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless unknown or not reasonably estimable. In that case, a statement to that effect may be made; and
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the new standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices).

C.06 These illustrative financial statements are not intended to include items that should be accounted for under the requirements of FASB ASC 815, *Derivatives and Hedging*, and do not reflect the requirements of FASB ASC 815. Practitioners should refer to FASB ASC 815 for guidance on reporting derivative instruments and hedging activities.

Exhibit C-1

The Property and Liability Insurance Company and Subsidiaries

Consolidated Balance Sheets
December 31, 20X2 and 20X1
(Dollars in thousands)

ASSETS	*20X2*	*20X1*
Investments (notes 1 and 2):		
Trading securities	$11,683	$11,259
Securities available for sale	1,006,279	953,507
Securities held to maturity	280,387	270,208
Mortgage loans on real estate (less allowance for credit losses, 20X2 $2,300; 20X1 $2,070)	472,509	398,426
Real estate, net of accumulated depreciation (20X2 $12,921; 20X1 $12,774) and less allowance for impairment of value (20X2 $1,173; 20X1 $1,150)	31,905	30,028
Total investments	1,802,763	1,663,428
Cash and cash equivalents	31,564	28,357
Accrued interest and dividends	31,358	27,568
Premium and agents' balances[1]	55,295	56,212
Prepaid reinsurance premiums	21,345	18,739
Reinsurance receivables, net of uncollectible amounts (note 3)	27,908	24,461
Deferred policy acquisition costs (note 1)	168,974	154,941
Property and equipment, at cost, less accumulated depreciation of $17,837 in 20X2 and $15,404 in 20X1 (note 1)	34,443	27,938
Other assets	128,577	107,378
TOTAL ASSETS	$2,302,227	$2,109,022

See accompanying notes to consolidated financial statements.

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[1] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 310, *Receivables*, and FASB ASC 942, *Financial Services—Depository and Lending*, require, among other things, that the summary of significant accounting policies include the basis for accounting for trade receivables, and the classification and method of accounting for other receivables. Receivables for property and liability entities include, but are not limited to, mortgage loans, agents' balances, premiums receivable, workers' compensation deductible recoveries, reinsurance recoverables, and securities on deposit with state insurance departments (which require financial statement disclosure). FASB ASC 310 requires that a description of the accounting policies and methodology the entity used to estimate its allowance for doubtful accounts be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments. In addition, FASB ASC 310 requires that the summary of significant accounting policies include the policy for charging off uncollectible trade receivables.

FASB ASC 310 contains other presentation and disclosure requirements that may apply to the financial statements of insurance entities. Readers should refer to the full text of FASB ASC 310. All of the disclosure requirements of FASB ASC 310 are not presented in these illustrative financial statements.

LIABILITIES	*20X2*	*20X1*
Losses and loss-adjustment expenses (notes 1 and 4)	$1,183,343	$1,030,345
Unearned premiums (note 1)	493,833	482,619
Dividends to policyholders	3,087	4,042
Reinsurance funds withheld and balances payable	15,727	35,584
Accrued expenses	85,780	82,608
Federal income taxes payable (notes 1 and 5)	3,166	7,058
Deferred income taxes (notes 1 and 5)	34,084	35,133
Other liabilities	56,144	43,782
Total liabilities	1,875,164	1,721,171
Commitments and contingencies (note 8)		
SHAREHOLDERS' EQUITY (note 7)		
Common stock ($5 par value authorized 11,500 shares; issued 2,500 shares, including 200 shares in treasury in 20X2 and 20X1)	12,500	12,500
Paid-in capital	22,500	22,500
Retained earnings (notes 6 and 7)	390,815	351,521
Accumulated other comprehensive income:		
Net unrealized appreciation on securities available-for-sale, net of deferred income taxes (20X2 – $3,095; 20X1 – $3,139)	5,748	5,830
Less treasury stock, at cost	(4,500)	(4,500)
Total shareholders' equity	427,063	387,851
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY[2]	$2,302,227	$2,109,022

See accompanying notes to consolidated financial statements.

[2] FASB ASC 480, *Distinguishing Liabilities from Equity*, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity.

Exhibit C-2

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Income
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands)

REVENUES	*20X2*	*20X1*
Premiums earned	$656,517	$603,461
Premiums ceded	(85,632)	(78,715)
Net premiums earned (notes 1 and 3)	570,885	524,746
Net investment income	146,683	130,070
Net realized gains and losses on investments and other (note 1)	84,776	32,272
Other	13,288	8,784
Total revenues	815,632	695,872
EXPENSE		
Losses and loss-adjustment expenses (notes 1 and 3)	509,568	432,413
Policyholder dividends (note 1)	4,833	7,395
Policy acquisition and other underwriting expenses (note 1)	211,239	185,834
Other	8,347	2,215
Total expenses	733,987	627,857
Income before income taxes	81,645	68,015
Provision (benefit) for income taxes (note 5)		
Current	26,108	16,291
Deferred	(1,007)	881
Total income taxes	25,101	17,172
NET INCOME	$56,544	$50,843

See accompanying notes to consolidated financial statements.

Exhibit C-3

The Property and Liability Insurance Company and Subsidiaries[3]

Consolidated Statements of Comprehensive Income
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands, except per share amounts)

	20X2	*20X1*
Net income	$56,544	$50,843
Other comprehensive income, net of tax:		
Unrealized holding gains on available-for-sale securities, net of tax expense of $29,627 and $12,312 in 20X2 and 20X1, respectively	55,022	22,865
Reclassification adjustments for amounts included in net income, net of tax expense of $(29,671) and $(11,295) in 20X2 and 20X1, respectively	(55,104)	(20,977)
Comprehensive income	$56,462	$52,731

[3] Note: If there was a cumulative effect of changes in accounting principles adopted to conform to the revised *Accounting Practices and Procedures Manual*, it would be shown in this schedule.

Exhibit C-4

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands)

	Common Stock						
	Shares	*Amount*	*Paid-in Capital*	*Accumulated Other Comprehensive Income (Loss)*	*Retained Earnings*	*Treasury Stock*	*Total Shareholders' Equity*
Balance at January 1, 20X1	2,500	$12,500	$22,500	$3,942	$315,678		$354,620
20X1							
Net income					50,843		50,843
Dividends ($6.00 per share)					(15,000)		(15,000)
Other comprehensive income (loss)				1,888			1,888
Purchase of 200 shares of treasury stock						(4,500)	(4,500)
Balance at December 31, 20X1	2,500	$12,500	$22,500	$5,830	$351,521	$(4,500)	$387,851
20X2							
Net income					56,544		56,544
Dividends ($7.50 per share)					(17,250)		(17,250)
Cumulative effect adjustment resulting from adoption of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*							
Other comprehensive income (loss)				(82)			(82)
Balance at December 31, 20X2	2,500	$12,500	$22,500	$5,748	$390,815	$(4,500)	$427,063

See accompanying notes to consolidated financial statements.

Exhibit C-5

The Property and Liability Insurance Company and Subsidiaries[4]

Consolidated Statements of Cash Flow
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands)

	20X2	*20X1*
Cash flows from operating activities:		
Premiums collected	$580,862	$536,532
Losses and loss adjustment expenses paid	(356,570)	(352,411)
Underwriting expenses paid	(208,067)	(184,006)
Net realized gains on available-for-sale securities	142,893	126,860
Net (increase) decrease in trading securities	(424)	1,095
Income taxes paid	(30,000)	(21,300)
Miscellaneous receipts (payments)	(45,701)	25,171
Net cash provided by operating activities	82,993	131,941
Cash flows from investing activities:		
Purchases of available-for-sale securities	(656,359)	(274,756)
Proceeds from sales of available-for-sale securities	590,644	195,826
Purchases of held-to-maturity securities	(49,826)	(176,871)
Proceeds from maturities of held-to-maturity securities	60,005	146,080
Purchase of property and equipment	(7,000)	(2,356)
Net cash used in investing activities	(62,536)	(112,077)
Cash flows from financing activities:		
Payment of dividends	(17,250)	(15,000)
Purchase of treasury shares	—	(4,500)
Net cash used in financing activities	(17,250)	(19,500)
Net increase (decrease) in cash	3,207	364
Cash and cash equivalents at beginning of year	28,357	27,993
Cash and cash equivalents at end of year	$31,564	$28,357
Reconciliation of net income to net cash provided by operating activities		

[4] Note: If there was a cumulative effect of changes in accounting principles adopted to conform to the revised *Accounting Practices and Procedures Manual*, it would be shown in this schedule.

	20X2	20X1
Net income	$56,544	$50,843
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,580	2,389
Gains on sales of investment	(84,776)	(32,272)
Increase in accrued interest and dividends	(3,790)	(2,983)
Increase in premium and agents' balances	917	(718)
Increase in prepaid reinsurance premiums	(2,606)	(1,953)
Increase in reinsurance receivable	(3,447)	(892)
Increase in deferred policy acquisition costs	(14,033)	(10,963)
Increase in unpaid losses and loss adjustment expenses	152,998	112,991
Increase in unearned premiums	11,214	9,816
Decrease in dividends payable	(955)	(820)
Decrease in reinsurance funds withheld	(19,857)	(18,152)
Increase in accrued expenses	3,172	2,915
Decrease in income taxes	(4,941)	(3,156)
Decrease (increase) in other net	(10,027)	24,896
Net cash provided by operating activities	$82,993	$131,941

See accompanying notes to consolidated financial statements.

Exhibit C-6

The Property and Liability Insurance Company and Subsidiaries

Notes to Consolidated Financial Statements
For the Years Ended December 31, 20X2 and 20X1

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. The Property and Liability Insurance Company and subsidiaries (the Company) is a nonpublic insurance organization providing property and liability coverage to both domestic and foreign markets. The Company is principally involved in writing insurance for domestic commercial lines.

The significant accounting policies followed by the Company are summarized as follows:

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of Consolidation. The consolidated financial statements include the accounts, after intercompany eliminations, of the Company and its subsidiaries.

Basis of Presentation. The accompanying financial statements have been prepared in conformity with generally accepted accounting principles that differ from statutory accounting practices prescribed or permitted for insurance entities by regulatory authorities.

Trading Securities. Bonds, notes, and redeemable and nonredeemable preferred stock held principally for resale in the near term are classified as trading securities and recorded at their fair values. Realized and unrealized gains and losses on trading securities are included in other income.

Securities Held to Maturity. Bonds, notes, and redeemable and nonredeemable preferred stock for which the insurance company has the intent and ability to hold to maturity are reported at amortized cost, adjusted for amortization of premiums or discounts and other-than-temporary declines in fair value. Realized gains and losses are determined using the specific identification method.

Securities Available for Sale. Bonds, notes, common stock, and redeemable preferred stock not classified as either trading or held-to-maturity are reported at fair value, adjusted for other than temporary declines in fair value, with unrealized gains and losses, net of tax, reported as a net amount in other comprehensive income. Realized gains and losses are determined using the specific identification method.

Mortgage Loans on Real Estate. Reported at unpaid balances, adjusted for amortization of premium or discount, less a provision for credit losses.

Real Estate. Reported at cost, less allowances for depreciation and impairment of value.

Cash Equivalents. Cash equivalents are short-term, highly liquid investments with original maturities of three months or less.

Recognition of Premium Revenues. Property and liability premiums are generally recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums.

Deferred Policy Acquisition Costs. Commissions and other costs of acquiring insurance that vary with and are primarily related to the production of new and renewal business are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. Amortization in 20X2 and 20X1 was approximately $58,000,000 and $55,000,000, respectively.

Effective January 1, 2007, the Company adopted new GAAP guidance related to internal replacement modifications.

As a result of the adoption of this guidance, if an internal replacement modification substantially changes a contract, then the deferred policy acquisition costs (DAC) is written off immediately through income and any new deferrable costs associated with the new replacement are deferred. If a contract modification does not substantially change the contract, the DAC amortization on the original contract will continue and any acquisition costs associated with the related modification are immediately expensed.

Property and Equipment. Property and equipment is recorded at cost and is depreciated principally under the straight-line method over the estimated useful lives of the respective assets.

Insurance Liabilities. The liability for losses and loss-adjustment expenses includes an amount determined from loss reports and individual cases and an amount, based on past experience, for losses incurred but not reported. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in earnings currently. The reserve for losses and loss-adjustment expenses is reported net of receivables for salvage and subrogation of approximately $17,527,000 and $16,276,000 at December 31, 20X2 and 20X1, respectively.

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Participating Policies. Participating business represents 6 percent of total premiums in force and premium income at December 31, 20X2, and 8 percent at

December 31, 20X1. The majority of participating business is composed of workers' compensation policies. The amount of dividends to be paid on these policies is determined based on the terms of the individual policies.

Reinsurance. In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy. The amount by which the liabilities associated with the reinsured policies exceed the amounts paid for retroactive reinsurance contracts is amortized in income over the estimated remaining settlement period using the interest method. The effects of subsequent changes in estimated or actual cash flows are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transactions, with a corresponding charge or credit to income.

Codification. The National Association of Insurance Commissioners (NAIC) revised the *Accounting Practices and Procedures Manual* in a process referred to as Codification. Codification became effective on January 1, 2001. The Company's state of domicile has adopted the provisions of the revised manual effective January 1, 2001. The revised manual has changed, to some extent, prescribed statutory accounting practices, and has resulted in changes to the Company's statutory-basis financial statements. The cumulative effect of changes in accounting principles adopted to conform to the revised *Accounting Practices and Procedures Manual* of $__has been reported as an adjustment to increase (decrease) surplus in the Company's statutory-basis financial statements as of January 1, 2001.

Income Taxes. The Company uses the asset and liability method as identified in FASB ASC 740, *Income Taxes*. Income tax provisions are based on the asset and liability method. Deferred federal income taxes have been provided for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Such differences are related principally to the deferral of policy acquisition costs and the recognition of salvage and subrogation on an accrual basis. The Company has adopted FASB ASC 740, related to uncertainties in tax contingencies, effective January 1, 20X2.

Income per Share of Common Stock. Income per share of common stock is based on the weighted average number of shares of common stock outstanding during each year. The effect of stock options is not material to the computation of earnings per share.

2. Investments

In reporting disclosures about investments in securities, entities should comply primarily with the requirements FASB ASC 320-50. Other disclosure requirements may also be applicable.

3. Reinsurance Activity

Substantial amounts of reinsurance are assumed, both domestic and foreign. Such reinsurance includes quota share, excess of loss, catastrophe, facultative, and other forms of reinsurance on essentially all property and casualty lines of insurance. The Company also cedes insurance to other entities and these reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At December 31, 20X2, reinsurance receivables with a carrying value of $8 million and prepaid reinsurance premiums of $5 million were associated with a single reinsurer. The Company holds collateral under related reinsurance agreements in the form of letters of credit totaling $5 million that can be drawn on for amounts that remain unpaid for more than 120 days.

The Company limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with other insurers or reinsurers, either on an automatic basis under general reinsurance contracts known as "treaties" or by negotiation on substantial individual risks. Ceded reinsurance is treated as the risk and liability of the assuming entities.

The effect of reinsurance on premiums written and earned for 20X2 and 20X1 are as follows:

(Dollars in thousands)

	20X2		*20X1*	
	Written	*Earned*	*Written*	*Earned*
Direct	$477,836	$457,828	$420,580	$415,369
Assumed	206,814	198,689	207,328	188,092
Ceded	(102,551)	(85,632)	(86,100)	(78,715)
Net	$582,099	$570,885	$541,808	$524,746

The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 20X2 and 20X1 were approximately $4,892,000 and $3,232,000, respectively.

4. Liability for Unpaid Losses and Loss Adjustment Expenses

Activity in the liability for unpaid losses and loss adjustment expenses is summarized as follows:

(Dollars in thousands)

	20X2	*20X1*
Balance at January 1	$1,030,345	$947,890
Less reinsurance recoverables	23,728	21,275
Net Balance at January 1	1,006,617	926,615
Incurred related to:		
Current year	509,843	429,294
Prior years	(275)	3,119
Total incurred	509,568	432,413
Paid related to:		
Current year	56,015	42,315
Prior years	300,555	310,096
Total paid	356,570	352,411
Net Balance at December 31	1,159,615	1,006,617
Plus reinsurance recoverables	23,728	23,728
Balance at December 31	$1,183,343	$1,030,345

As a result of changes in estimates of insured events in prior years, the provision of losses and loss adjustment expenses (net of reinsurance recoveries of $X and $X in 20X2 and 20X1, respectively) decreased by $275 in 20X2 because of lower-than-anticipated losses on Hurricane Howard, and increased by $3,119 in 20X1 because of higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

5. Income Taxes

The U.S. Federal statutory income tax rate applicable to ordinary income is 34 percent for 20X2 and 20X1. The Company's effective federal income tax rate is less than the statutory rate due primarily to tax exempt interest, dividends-received deduction, and fresh start adjustments.

The components of the net deferred tax liability are as follows:

	(Dollars in thousands)	
	20X2	*20X1*
Deferred policy acquisition costs	$17,093	$17,298
Salvage and subrogation	12,901	11,736
Other	4,090	6,101
Deferred tax liability	$34,084	$35,135

The Company has net operating loss carryforwards for tax purposes of $35,297 and investment tax credit carryforwards of $49,396. The tax loss carryforwards (if not utilized against taxable income) and investment tax credit carryforwards expire beginning in 20XX and continuing through 20YY.

The Company paid income taxes of $30,000 in 20X2 and $21,300 in 20X1.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 20XX. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20XX through 20YY in the first quarter of 20X2 that is anticipated to be completed by the end of 20X2. As of December 31, 20X2, the IRS has proposed certain significant adjustments to the Company's transfer pricing tax positions. Management is currently evaluating those proposed adjustments to determine if it agrees, but if accepted, the Company does not anticipate the adjustments would result in a material change to its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of $XX to $YY million will be made by the end of 20X2.

The Company adopted the provisions of FIN 48 on January 1, 20X2. As a result of the implementation of FIN 48, the Company recognized approximately a $2xx million increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 20X2, balance of retained earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	(in thousands)
Balance at January 1, 20X2	$XX
Additions based on tax positions related to the current year	$XX
Additions for tax positions of prior years	$XX
Reductions for tax positions of prior years	$(XX)
Settlements	$(XX)
Balance at December 31, 20X2	$XX

Included in the balance at December 31, 20X2, are $XX million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 20X2 and 20X1, the Company recognized approximately $XX and $XX million in interest and penalties. The Company had approximately $XX and $50XX million for the payment of interest and penalties accrued at December 31, 20X2, and 20X1, respectively.

6. Dividends From Subsidiaries

The funding of the cash requirements of the Company (parent company) is primarily provided by cash dividends from the Company's subsidiaries. Dividends paid by the insurance subsidiaries are restricted by regulatory requirements of the domiciliary states. Generally, the maximum dividend that may be paid without prior regulatory approval is limited to the greater of 10 percent of statutory surplus (shareholders' equity on a statutory basis) or 100 percent of net investment income for the prior year. Dividends exceeding these limitations can generally be made subject to approval by various state insurance departments. The subsidiaries paid cash dividends to the Company of $24,754,000 and $22,100,000 in 20X2 and 20X1, respectively. At December 31, 20X2, the maximum dividend that may be paid to the Company in 20X3 without regulatory approval is approximately $146,000,000.

7. Statutory Net Income and Shareholders' Equity

The Company, which is domiciled in ABC State, prepares its statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the ABC state insurance department, which (state of domicile) recognizes for determining solvency under the (state of domicile) Insurance Law. The commissioner of the state of domicile Insurance Department has the right to permit other practices that may deviate from prescribed practices.

Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in (state of domicile). Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from entity to entity within a state, and may change in the future.

Note: *Although the following statutory financial information is not required to be disclosed in financial statements prepared in conformity with GAAP, insurance entities sometimes include such disclosures to facilitate use of those financial statements for purposes of filing with state regulatory authorities. The second disclosure is required under SOP 01-5,* Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.

Generally accepted accounting principles differ in certain respects from the accounting practices prescribed or permitted by insurance regulatory authorities (statutory basis). Statutory net income was approximately $35.7 million and $52.7 million in 20X2 and 20X1, respectively, and statutory shareholders' equity, including the effects of prescribed and permitted practices was approximately $347.2 million and $299.7 million at December 31, 20X2 and 20X1, respectively.

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the NAIC's *Accounting Practices and Procedures Manual* as the basis of its statutory accounting practices (NAIC statutory accounting principles [SAP]), except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $___ million and $___ million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $___ million and $___ million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $___ million and $___ million at December 31, 20X2 and 20X1, respectively.

8. Contingencies

In November ___, California voters passed Proposition 103, requiring insurers doing business in that state to roll back property/casualty premium prices to November ___levels, less an additional 20 percent discount. Insurers challenged the constitutionality of Proposition 103, and in May ___the California Supreme Court upheld the proposition in large part. However, the Court also ruled that the rollback provision does not apply to an insurer who demonstrates through rate filings that the rate rollback would not allow a "fair and reasonable return." The Company filed for exemption from the rate rollback for all lines affected by Proposition 103. In September ___, the California Insurance Commissioner announced that the Company would be afforded a hearing and, using different assumptions and methods than prescribed for the original filing, determined that the Company should roll back its rates and refund premiums of $19 million. The Company disagrees with the Commissioner's methods and conclusions, and no provision for potential rate rollbacks or premium refunds is reflected in the financial results.

In October ___, the Commissioner suspended the individual hearings and began a consolidated hearing, in which the Company is participating, intended to define the generic issue of the methods to be used to calculate potential rate rollbacks and analyze future rate filings. Until the generic issues are resolved in the Commissioner's consolidated hearing, there will be uncertainty as to whether the Company will ultimately be required to roll back any of its rates or refund any premiums. Management believes such rate rollbacks and premium refunds, if any, would not have a material adverse effect on the Company's financial position.

9. Concentrations of Credit Risk

At December 31, 20X2, the Company held unrated or less-than-investment grade corporate debt securities of $_____ net of reserves for losses, with an aggregate market value of $_____. Those holdings amounted to 6 percent of the Company's corporate debt securities investments and less than 3 percent of total assets. The holdings of less-than-investment grade securities are widely diversified and of satisfactory quality based on the Company's investment policies and credit standards. The Company also invests in mortgage loans principally involving commercial real estate. At December 31, 20X2, 20 percent of such mortgages ($ ________) involved properties located in California and Arizona. Such investments consist of first mortgage liens on completed income-producing properties, and mortgages on individual properties do not exceed $_____.

10. Fair Value of Financial Instruments[5]

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value in conformity with FASB ASC 820, *Fair Value Measurements and Disclosures*:

> *Cash and Short Term Investments*. For those short term instruments, the carrying amount is a reasonable estimate of fair value.
>
> *Investment in Securities*. For investments in securities, fair values are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

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[5] FASB ASC 825-50-3 makes the disclosures about fair value of financial instruments as prescribed in FASB ASC 825, *Financial Instruments*, optional for entities that meet all of the following criteria:

a. The entity is a *nonpublic entity* (as defined in the FASB ASC glossary).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB ASC 815, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

FASB ASC 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value that applies broadly to financial and nonfinancial assets and liabilities and improves the consistency, comparability, and reliability of the measurements.

Mortgage Loans on Real Estate and Policy Loans. The fair value of mortgage loans on real estate is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of policy loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to contract holders with similar credit ratings and the same remaining maturities.

The estimated fair values of the Company's financial instruments which are not disclosed on the face of the balance sheet or elsewhere in the notes are as follows:

	20X2		*20X1*	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Mortgage on real estate loans	$472,509	$474,163	$398,426	$401,582
Policy loans	19,862	20,974	18,623	19,953

Appendix D

NAIC Insurance Regulatory Information System[1]

The National Association of Insurance Commissioner (NAIC) Insurance Regulatory Information System (IRIS) was developed to assist the state insurance departments in monitoring financial conditions of property and liability insurance entities. The system uses financial ratios to identify entities that may be having financial difficulties. Such priority entities can then be targeted for closer surveillance or perhaps for on-site examination. IRIS ratio results are kept confidential through the period when the ratios are calculated. They are made available only to the entity and to the state of domicile insurance department. After a period of review by the entity and the domiciliary state regulator, the ratio results are published by the NAIC.

Financial Ratios

Financial ratios can be categorized as overall ratios, profitability ratios, liquidity ratios, or reserve ratios. A brief description of each of the individual ratios and the acceptable results (based on the guidance in effect in 2001) follows.

Overall Ratios

Gross premiums written to policyholders' surplus. An entity's policyholders' surplus provides a cushion for absorbing above-average losses. This ratio measures the adequacy of this cushion, net of the effects of premiums ceded to reinsurers. The higher the ratio, the more risk the entity bears in relation to the policyholders' surplus available to absorb loss variations. This ratio is calculated by dividing gross premiums written by policyholders' surplus. The results of this test should include results up to 900 percent.

Net premiums written to policyholders' surplus. An entity's surplus provides a cushion for absorbing above-average losses. This ratio measures the adequacy of this cushion. The higher the ratio, the more risk the entity bears in relation to the surplus available to absorb loss variations. This ratio is calculated by dividing net premiums written by policyholders' surplus. The results of this test should be less than 300 percent.

Change in net writings. Major increases or decreases in net premiums written indicate a lack of stability in the entity's operations. A large increase in premium may signal abrupt entry into new lines of business or sales territories. In addition, such an increase in writings may indicate that the entity is increasing cash inflow in order to meet loss payments. A large decrease in premiums may indicate the discontinuance of certain lines of business, scaled back writings due to large losses in certain lines, or loss of market share due to competition. The usual range for this ratio is from -33 percent to 33 percent.

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[1] Using the National Association of Insurance Commissioner Insurance Regulatory Information System, NAIC, Kansas City, Kansas.

Surplus aid to policyholders' surplus. The use of surplus aid reinsurance treaties may be taken as an indication that entity management believes policyholders' surplus to be inadequate. In addition, the continued solvency of entities with a large portion of policyholders' surplus deriving from surplus aid may depend upon the continuing cooperation of the reinsurer. The usual range for the test is less than 15 percent.

Profitability Ratios

Two-year overall operating ratio. The overall operating ratio is a measure of the operating profitability of an insurance entity. Over the long run, the profitability of the business is a principal determinant of the entity's financial solidity and solvency. The usual range for this test is less than 100 percent.

Investment yield. In addition to measuring one important element in profitability, the investment yield also provides an indication of the general quality of the entity's investment portfolio. The usual range for this test is greater than 4.5 percent and less than 10 percent.

Change in policyholders' surplus. The change in policyholders' surplus is, in a sense, the ultimate measure of the improvement or deterioration of the entity's financial condition during the year. The usual range for this test is from a decrease of 10 percent to an increase of 50 percent.

Liquidity Ratios

Liabilities to liquid assets. The ratio of total liabilities to liquid assets is a measure of the entity's ability to meet the financial demands that may be placed upon it. It also provides a rough indication of the possible implications for policyholders if liquidation becomes necessary. The usual range for this test is less than 105 percent.

Gross agents' balances to policyholders' surplus. The ratio of agents' balances to policyholders' surplus measures the degree to which solvency depends on an asset that frequently cannot be realized in the event of liquidation. In addition, the ratio is reasonably effective in distinguishing between troubled and solid entities. The usual range for this test is less than 40 percent.

Reserve Ratios

One-year reserve development to policyholders' surplus. This ratio measures the accuracy with which reserves were established one year ago. The usual range for this test is less than 20 percent.

Two-year reserve development to policyholders' surplus. The two-year reserve development to surplus ratio is calculated in a manner similar to the calculation in the one-year reserve development test. The two-year reserve development is the sum of the current reserve for losses incurred more than two years prior, plus payments on those losses during the past two years minus the reserves that had been established for those losses two years earlier. The usual range for this test is less than 20 percent.

Estimated current reserve deficiency to policyholders' surplus. This ratio provides an estimate of the adequacy of current reserves. The usual range for this test is less than 25 percent.

Unusual circumstances precluded, an entity would be considered a priority entity if it failed four or more ratios. As previously discussed, the results of the NAIC IRIS financial ratios should be reviewed and results outside the usual ranges investigated and explained.

Appendix E

Examples of Development Data

A common approach to estimating loss reserves for occurrence policies is to compile a history of the development of losses for each accident year, reviewing the historical patterns and projecting the ultimate expected losses using such patterns. Similarly, for claims-made policies, report year would be substituted for accident year. Two examples of this approach are included herein.

Although such developments are very useful in testing loss-reserve estimates, the auditor should consider the adequacy of the entity's data base and the stability of loss-payment patterns. The auditor should keep in mind that there are other methods, retrospective and prospective, that may be more appropriate or that should be used in conjunction with the historical development method.

Example A. Table 1 represents a compilation of historical incurred loss-development data arrayed by accident year, by development period. Development period 12, for example, displays the amount of incurred losses (paid plus outstanding) after 12 months. For 19X0, $8,123 was incurred at the end of 12 months. Likewise, the subsequent development periods display the incurred losses for a given accident year at the various points in time; for example, the developed loss for 19X2 at the end of 48 months (that is, 19X5) is $9,435, and the developed loss for 19X3 at the end of 36 months (also 19X5) is $8,208.

Table 2 provides an estimate of the IBNR reserve by (1) computing the "period-to-period development factors" (section I); (2) computing the average factor for each development period (section II); (3) computing a period-to-ultimate factor (section III), which is the product of the successive period-to-period development factors; (4) estimating ultimate expected losses by multiplying the period-to-ultimate factor by the losses incurred to date (section IV); and estimating the incurred but not reported (IBNR) reserve (section VI) as the difference between the ultimate expected losses and losses incurred to date (table 1).

This example considers only simple averages to derive the period-to-period factors. Actual applications of this approach also should consider weighted averages and averages of the more recent history (three or four years) in determining the appropriate period-to-period factors to be used. The use of various averages will aid in determining trends and minimizing the effects of random variation.

Example B. Example B demonstrates an approach similar to example A, except that paid loss data are used rather than incurred loss data. The computations are made in the same manner as for example A; however, the resulting estimate is an estimate of both the case and the IBNR reserves.

Example A—Table 1 Incurred Loss Data

Accident Year	*Development Period (Months)*									
	12	*24*	*36*	*48*	*60*	*72*	*84*	*96*	*108*	*120*
19X0	8,123	8,593	8,896	8,919	8,929	8,932	8,933	8,933	8,933	8,933
19X1	8,345	8,459	8,621	8,894	8,992	8,890	8,885	8,886	8,886	
19X2	8,603	9,033	9,524	9,435	9,500	9,545	9,546	9,546		
19X3	8,002	8,621	8,208	8,288	8,419	8,365	8,363			
19X4	9,620	10,191	9,684	9,750	9,731	9,734				
19X5	7,443	8,448	8,870	8,975	8,988					
19X6	7,815	9,435	9,735	9,582						
19X7	11,089	12,319	12,174							
19X8	11,323	12,684								
19X9	12,533									

Example A—Table 2 Period-to-Period Development Factor

		(Months)									
	Accident Year	*12–24*	*24–36*	*36–48*	*48–60*	*60–72*	*72–84*	*84–96*	*96–108*	*108–120*	*Estimated Tail*
I.	19X0	1.058*	1.035	1.003	1.001	1.000	1.000	1.000	1.000	1.000	†
	19X1	1.014	1.019	1.032	1.011	0.989	0.999	1.000	1.000		
	19X2	1.050	1.054	0.991	1.007	1.005	1.000	1.000			
	19X3	1.077	0.952	1.010	1.016	0.994	1.000				
	19X4	1.059	0.950	1.007	0.998	1.000					
	19X5	1.135	1.050	1.012	1.001						
	19X6	1.207	1.032	0.984							
	19X7	1.111	0.988								
	19X8	1.120									
II.	Average	1.092	1.010	1.005	1.006	0.998	1.000	1.000	1.000	1.000	
III.	Ultimate	1.113‡	1.019	1.009	1.003	0.998	1.000	1.000	1.000	1.000	1.000
		19X9	*19X8*	*19X7*	*19X6*	*19X5*	*19X4*	*19X3*	*19X2*	*19X1*	*19X0*
IV.	Ultimate Losses	13,949	12,923	12,279	9,613‖	8,966	9,733	8,363	9,546	8,886	8,933
V.	Last Diagonal # (paids + case outstanding)	12,533	12,684	12,174	9,582	8,988	9,734	8,363	9,546	8,886	8,933
VI.	IBNR Reserve	1,416 **	239	105	31	(22)	(1)	0	0	0	0

The above triangle utilizes an "incurred-to-incurred" approach in developing an estimate for IBNR reserves.

* Twenty-four-month developed losses divided by 12-month-developed loss from table 1 (8,593 ÷ 8,123 = 1.058).

† Applies only if development period is longer than the period covered by the model.

‡ The product of the remaining factors (1.092 x 1.010 x 1.005 x 1.006 x .988 x 1.000 = 1.113) or the product of the 12–24 average factor times the 24–36 ultimate factor (91.092 x 1.019 = 1.113).

‖ The product of the developed losses times the ultimate factor (12,533 x 1.113 = 13,949; 9,582 x 1.003 = 9,613; etc.).

\# Losses incurred to date from table 1.

** The difference between ultimate estimated losses and losses developed to date (13,949 x 12,533 = 1,416).

Example B—Table 1 Cumulative Paid Loss Data

Accident Year	Development Period (Months)								
	12	24	36	48	60	72	84	96	108
	($000)								
19X0	47	210	335	422	481	506	527	543	548
19X1	52	197	312	377	430	469	496	501	
19X2	52	185	273	348	407	437	479		
19X3	41	172	282	366	425	468			
19X4	41	203	319	410	479				
19X5	44	175	308	443					
19X6	44	174	282						
19X7	51	208							
19X8	68								

Example B—Table 2 Period-to-Period Development Factor

Accident Year	*12–24*	*24–36*	*36–48*	*48–60*	*60–72*	*72–84*	*84–96*	*96–108*	*Estimated Tail*	
	(Months)									
19X0	4.468	1.595	1.260	1.140	1.052	1.042	1.030	1.009	*	
19X1	3.788	1.584	1.208	1.141	1.091	1.058	1.010			
19X2	3.558	1.476	1.275	1.170	1.074	1.096				
19X3	4.195	1.640	1.298	1.161	1.101					
19X4	4.951	1.571	1.285	1.168						
19X5	3.977	1.760	1.438							
19X6	3.955	1.621								
19X7	4.078									
19X8										
19X9										
Average	4.121	1.607	1.294	1.156	1.080	1.065	1.020	1.009		
Ultimate	12.895	3.129	1.948	1.505	1.302	1.206	1.133	1.110	1.100	
	19X8	*19X7*	*19X6*	*19X5*	*19X4*	*19X3*	*19X2*	*19X1*	*19X0*	*Total*
Ultimate	877	651	549	667	624	565	543	556	515	
Last Diagonal	68	208	282	443	479	468	479	501	468	
Case + IBNR Reserve	809	443	267	224	145	97	64	55	47	2,149

The above triangle utilizes a paid loss approach in developing an estimate for total loss reserves. Note that both examples are prepared on an accident-year basis. Models can also be prepared on a policy-year basis. Computations are the same as explained in example A.

* Applies only if development period is longer than the period covered by the model.

Appendix F

Industry and Other Organizations

The following is a list of some of the industry organizations. These sources are useful to the auditor in obtaining an understanding of the insurance industry.

American Academy of Actuaries (AAA) was founded in 1965 to represent the profession by four specialty actuarial associations: The Casualty Actuarial Society, Conference of Actuaries in Public Practice, Fraternal Actuarial Association, and Society of Actuaries. It provides standards or criteria of competence as an actuary and promotes education in actuarial science, exchange of information among actuarial organizations, and maintenance of standards of conduct and competence. The Casualty Actuarial Society provides actuarial and statistical science in insurance other than life insurance. The AAA website can be accessed at www.actuary.org.

American Insurance Association (AIA) is a property casualty insurance trade organization. In 1964, the old AIA merged with the National Board of Fire Underwriters and the Association of Casualty and Surety Companies and became the present-day AIA. The AIA represents its members in every state and at the federal level in legislative, regulatory, and legal forums to assure its members a role in shaping insurance public policy. The AIA website can be accessed at www.aiadc.org.

Group of North American Insurance Enterprises (GNAIE) consists of the Chief Financial Officers of the leading U.S. insurance entities including life insurers, property and casualty insurers, and reinsurers. GNAIE members include entities that are the largest global providers of insurance and substantial multinational corporations. GNAIE provides commentary on international accounting standard setting and facilitates communication among insurers, the FASB, and the IASB. The GNAIE website can be accessed at www.gnaie.net.

Independent Insurance Agents and Brokers of America (IIABA) promotes agent and broker education and supports legislation of interest to the public as well as the insurance industry and opposes legislation detrimental to members' interests. The IIABA website can be accessed at www.iiaba.net.

Insurance Accounting and Systems Association (IASA) provides education and training with respect to insurance accounting and systems. The IASA website can be accessed at www.iasa.org.

Insurance Information Institute (III) serves as the vehicle for a better public understanding and acceptance of the insurance business. The III website can be accessed at www.iii.org.

Insurance Regulatory Examiners Society (IRES) is an association of professional insurance regulators dedicated to consumer protection. IRES helps to promote fair, cost effective, and efficient insurance regulation by ensuring professionalism and integrity among the individuals who serve state and federal insurance regulatory bodies. Examiners come together for training and to share and exchange information on a formal and informal level. The IRES website can be accessed at www.go-ires.org.

Insurance Service Office (ISO) acts as the bureau developing rates and forms for many lines of insurance. The ISO website can be accessed at www.iso.com.

National Association of Independent Insurance Adjusters (NAIIA) is a national trade organization offering a central contract point for professionals in the business of insurance claims to network effectively by exchanging current news of the marketplace and sharing marketing contacts and methods. The NAIIA website can be accessed at www.naiia.com.

National Association of Insurance Commissioners (NAIC) is an organization of the chief insurance regulatory officials of the 50 states, the District of Columbia, and 5 U.S. Territories. It provides a forum for the exchange of ideas and the formulation of uniform policy. The NAIC helps state commissioners fulfill their obligations of protecting the interests of insurance policyholders. The NAIC website can be accessed at www.naic.org.

National Association of Mutual Insurance Companies (NAMIC) comprises mutual fire and casualty insurance entities. The association gathers, compiles, and analyzes information on all matters relating to insurance and to the reduction and prevention of losses. It also conducts workshops and seminars on these matters. The NAMIC website can be accessed at www.namic.org.

National Association of Professional Insurance Agents (PIA) acts in a capacity similar to that of the Independent Insurance Agents and Brokers of America. The PIA website can be accessed at www.pianet.com.

National Council on Compensation Insurance (NCCI) develops and administers rating plans and systems for workers' compensation insurance. The NCCI website can be accessed at www.ncci.com.

Property Casualty Insurers Association of America (PCI) is a property/casualty trade association in the United States. It addresses broad questions of position on proposed legislation and regulation, establishment of good public relations, and methods of conducting the business. The PCI website can be accessed at www.pciaa.net.

Reinsurance Association of America (RAA) acts as spokesperson for reinsurance entities in regulatory matters and in promotion of the interests of the industry. The RAA website can be accessed at www.reinsurance.org.

Society of Financial Examiners (SOFE) is a professional society for examiners of insurance entities, banks, savings and loans, and credit unions where financial examiners come together for training and to share and exchange information on a formal and informal level. The SOFE website can be accessed at www.sofe.org.

Society of Insurance Financial Management (SIFM) provides a forum for discussion and dissemination of information on accounting, statistical, and management problems in the insurance industry. The SIFM website can be accessed at www.sifm.org.

Appendix G

Information Sources

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Organization	General Information	Fax Services	Website	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* The Palladian 220 Leigh Farm Road Durham, NC 27707-8110 (888) 777-7077		www.aicpa.org www.cpa2biz.com	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
International Accounting Standards Boards	*First Floor* *30 Cannon Street* *London, EC4M 6XH* *United Kingdom*		www.iasb.org	
National Association of Insurance Commissioners	*Order Department* 2301 McGee Street Suite 800 Kansas City, MO 64108 (816) 783-8300	*Order by Fax* (816) 460-7593	www.naic.org	
Public Company Accounting Oversight Board	*1666 K Street, NW* *Washington, DC 20006-2803*		www.pcaobus.org	
U.S. Government Accountability Office	441 G St., NW Washington, DC 20548 (202) 512-3000 Publications (202) 512-6000	*Information Line* (202) 512-3000	www.gao.gov	
U.S. Government Printing Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-1800	www.gpo.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 100 F Street, NE Washington, DC 20549 (202) 551-6551	*Information Line* (202) 942-8088 (202) 551-6020 (tty)	www.sec.gov	

Appendix H

International Financial Reporting Standards

Introduction

The following information provides a discerning look at the globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that U.S. generally accepted accounting principles (GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing acceptance of IFRSs, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. Nearly 117 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies (approximately 90 countries have fully conformed to IFRSs as promulgated by the International Accounting Standards Board [IASB] and include a statement acknowledging such conformity in audit reports). Other countries, including Canada, are expected to transition to IFRSs by 2011. Mexico plans to adopt IFRSs for all listed companies starting in 2012. Other countries have plans to converge (or eliminate significant differences between) their national standards and IFRSs.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with IFRSs as issued by the IASB. In addition, the SEC continues to analyze and evaluate appropriate steps toward, and challenges related to, converging U.S. GAAP with IFRSs, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's systematically important industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost benefits are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Overwhelming internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.

Who is the IASB?

The IASB is the privately-funded independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. The IASB is funded by contributions from the major accounting firms, private financial institutions, and industrial companies around the world; central and development banks; and other international and professional organizations. Although the AICPA was a founding member of the International Accounting Standards Committee (IASC), the IASB's predecessor organization, it is not affiliated with the IASB.

The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (*a*) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (*b*) the IFRS Advisory Council; and (*c*) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The members of the IASB currently represent nine countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities* (*IFRS for SMEs*), and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

- Standards, whether labeled IFRSs or International Accounting Standards (IASs)[1]
- Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)[2]

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[1] See www.iasb.org for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

[2] See www.iasb.org for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

The preface to the IFRS 2009 Bound Volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to apply to not-for-profit entities or those in the public sector,[3] but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* (IASB Framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IFRS Foundation is guided by the IASB Framework in the development of future standards and in its review of existing standards. The IASB Framework is not an IFRS, and when there is a conflict between the IASB Framework and any IFRS, the standard will prevail. The IASB Framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (*a*) represent faithfully the financial position, financial performance, and cash flows of the entity; (*b*) reflect the economic substance of transactions, other events, and conditions; (*c*) are neutral; (*d*) are prudent; and (*e*) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

- The requirements and guidance in IFRSs dealing with similar and related issues
- The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IASB Framework
- The most recent pronouncements of other standard setting bodies (for example, U.S. GAAP, other accounting literature, and accepted industry practices) to the extent that these do not conflict with IFRSs

IFRS for SMEs

IFRS for SMEs is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

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[3] Generally speaking, *public* means government-owned entities, and *private* means nongovernment-owned entities.

SMEs are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of GAAP.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to IFRS for SMEs.[4]

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at http://wiki.ifrs.com/.

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[4] CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

The Financial Accounting Standards Board and IASB Convergence Efforts[5]

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a "Memorandum of Understanding" (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company's transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential of different interpretations for similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company's industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.
- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

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[5] Because the convergence projects discussed are active and subject to change, updates will be posted periodically to www.journalofaccountancy.com. Readers also are encouraged to monitor the progress of these projects at the respective boards' websites: www.iasb.org and www.fasb.org.

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for example, IAS 41, *Agriculture*)[6] that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

SEC Work Plan

The SEC continues to affirm its continuing support for a single set of high-quality, globally accepted accounting standards and for the convergence of U.S. GAAP and IFRSs. In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to Release No. 33-8982, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. The February 2010 release provides a confirmation of the SEC's continued support for convergence, highlights positive aspects of narrowing the differences between the two sets of standards, and outlines additional considerations required before adoption of a single standard is achieved.

The release also states that a more comprehensive work plan is necessary to lay out the work required to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, timeframe, and methodology for any such transition. The SEC has indicated that it will carefully consider and deliberate whether a potential transition is in the best interest of U.S. investors and markets.

By 2011, assuming completion of the convergence projects and the SEC staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. The work plan is included

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[6] In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

as an appendix at the end of the SEC's release, which is located on the SEC's website at www.sec.gov.

AICPA

On February 24, 2010, president and CEO of the AICPA Barry Melancon issued a statement on the SEC's plan to work toward the incorporation of IFRSs in the U.S. financial reporting system. The statement noted that the AICPA supports the thoughtful and concrete steps the SEC is taking, as outlined in its plan, to prepare for the transition. The AICPA understands that it will need to fulfill a number of responsibilities to make the use of IFRSs in the United States a success. Ongoing efforts include the following:

- Continuing to educate AICPA members about IFRSs
- Working with accounting educators, textbook authors, and educational institutions to prepare future professionals to use IFRSs
- Making certain the voice of U.S. CPAs is heard internationally
- Incorporating questions about IFRSs into the Uniform CPA Exam

The AICPA believes that it is critical for the SEC to set a specific date for the use of IFRSs in the United States and encourages the SEC, as it completes this work plan in 2011, to ensure investor confidence is maintained and key milestones lead successfully to global standards in 2015. In moving forward, it is essential that all stakeholders—regulators, investors, auditors, educators, financial statement users, and preparers—have the knowledge and tools they need to successfully navigate any change in U.S. accounting rules. The AICPA is doing its part now to prepare these stakeholders for this fundamental shift in financial reporting.

Additional Resources

Website	*URL*
AICPA	www.aicpa.org
AICPA International Financial Reporting Standards Resources	www.ifrs.com
International Accounting Standards Board	www.iasb.org
Comparison Wiki of *International Financial Reporting Standard for Small- and Medium-sized Entities* and U.S. generally accepted accounting principles	http://wiki.ifrs.com
Financial Accounting Standards Board	www.fasb.org

Appendix I

Schedule of Changes Made to the Text From the Previous Edition

As of June 1, 2010

This schedule of changes identifies areas in the text and footnotes of this guide that have that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or re-ordering that occurred in the updating of this guide.

Reference	*Change*
Preface	Updated.
Footnote 1 in paragraph 1.01	Revised for clarification.
Paragraphs 1.59–.60	Revised for updates to the Terrorism Risk Insurance Act.
Footnote † in paragraph 1.56	Added to discuss Securities and Exchange Commission (SEC) Compliance and Disclosure Interpretation *Non-GAAP Financial Measures*.
Paragraph 1.65	Revised for updated statutory hierarchy.
Footnote ǁ to heading before paragraph 1.81	Added to discuss Financial Accounting Standards Board (FASB) International Accounting Standards Board (IASB) joint insurance contracts project.
Table 1-1	Revised for updated guidance.
Paragraph 2.37	Revised for clarification.
Paragraph 2.71	Revised for AU Section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1).
Paragraphs 2.107, 2.109–.110, 2.112–.113, and 2.118–.119	Revised for updates to the National Association of Insurance Commissioners revised Model Audit Rule.
Footnote † to heading before paragraph 3.30	Added to discuss FASB IASB joint insurance contracts project.

(continued)

Reference	*Change*
Footnote * to heading before paragraph 4.01	Added to discuss FASB IASB joint insurance contracts project.
Paragraph 4.02	Revised for FASB *Accounting Standards Codification*™ (ASC).
Footnote * in paragraph 5.06	Added to include SEC Dear CFO letters.
Footnote † to heading before paragraph 5.26	Added to discuss FASB and IASB fair value measurement project.
Paragraphs 5.73–.75	Added for GAAP impairment guidance.
Paragraphs 5.105–.106	Added to include Statement of Statutory Accounting Principle (SSAP) No. 43R guidance.
Paragraph 5.109	Added to include SSAP No. 43R impairment guidance.
Paragraph 5.136	Revised to include SSAP No. 97 guidance.
Footnote * to heading before paragraph 6.22	Added to discuss FASB IASB joint insurance contracts project.
Paragraph 7.02	Revised to include the American Recovery and Reinvestment Act of 2009.
Paragraphs 7.21 and 7.39–.40	Revised to include SSAP No. 10R guidance.
Paragraphs 7.42–.48	Revised to include disclosure guidance.
Appendix C	Revised for FASB ASC references.
Appendix H	Revised for International Financial Reporting Standards.

Glossary

The following terms can be found in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary:

acquisition cost. Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts.

annuity contract. A contract in which an insurance entity unconditionally undertakes a legal obligation to provide specified pension benefits to specific individuals in return for a fixed consideration or premium. An annuity contract is irrevocable and involves the transfer of significant risk from the employer to the insurance entity.

assuming entity (or company). The party that receives a reinsurance premium in a reinsurance transaction. The assuming entity (or reinsurer) accepts an obligation to reimburse a ceding entity under the terms of the reinsurance contract.

captive insurers. An insurance entity that primarily does business with related entities.

ceding company (entity). The party that pays a reinsurance premium in a reinsurance transaction. The ceding entity receives the right to reimbursement from the assuming entity under the terms of the reinsurance contract.

claim. A demand for payment of a policy benefit because of the occurrence of an insured event.

cost recovery method. A revenue recognition method under which premiums are recognized as revenue in amounts equal to estimated claim costs when insured events occur until the ultimate premium is reasonably estimable and recognition of income is postponed until that time.

deposit method. A revenue recognition method under which premiums are not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

fronting. Reinsurance arrangements in which the ceding entity issues a policy and reinsures all or substantially all of the insurance risk with the assuming entity.

group insurance. Insurance protecting a group of persons, usually employees of an entity and their dependents. A single insurance contract is issued to their employer or other representative of the group. Individual certificates often are given to each insured individual or family unit. The insurance usually has an annual renewable contract period, although the insurer may guarantee premium rates for two or three years. Adjustments to premiums relating to the actual experience of the group of insured persons are common.

incurred but not reported claims. Claims relating to insured events that have occurred, but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

incurred losses (claims). Losses paid or unpaid for which the entity has become liable during a period.

liability for (claim) adjustment expenses. The amount needed to provide for the estimated ultimate cost required to investigate and settle losses relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date), whether or not reported to the insurer at that date.

liability for unpaid claims. The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date).

maintenance costs. Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

morbidity. The relative incidence of disability because of disease or physical impairment.

mortgage guaranty insurance enterprise. An insurance enterprise that issues insurance contracts that guarantee lenders, such as savings and loan associations, against nonpayment by mortgagors.

mutual company (entity). An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, and participants. Mutual insurance entities, credit unions, and farm and rural electric cooperatives are examples of mutual entities.

participating insurance. Insurance in which the contract holder is entitled to participate in the earnings or surplus the insurance entity. The participation occurs through the distribution of dividends to policyholders.

property and liability insurance enterprise. An enterprise that issues insurance contracts providing protection against either of the following: (1) damage to, or loss of, property caused by various perils, such as fire and theft, or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises also can issue accident and health insurance contracts. The term property and liability insurance enterprise is the current terminology used to describe a fire and casualty insurance enterprise. Property and liability insurance enterprises may be either stock or mutual organizations.

reinsurance. A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the policyholder for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

reinsurance receivables. All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits.

retroactive reinsurance. Reinsurance in which an assuming entity agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

risk of adverse deviation. A concept used by life insurance enterprises in estimating the liability for future policy benefits relating to long-duration contracts. The risk of adverse deviation allows for possible unfavorable deviations from assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses. The concept is referred to as risk load when used by property and liability insurance enterprises.

subrogation. The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

termination. In general, the failure to renew an insurance contract. Involuntary terminations include death, expirations, and maturities of contracts. Voluntary terminations of life insurance contracts include lapses with or without cash surrender value and contract modifications that reduce paid-up whole life benefits or term life benefits.

The following is a list of additional terms that have been used in this guide:

abstract. A form containing basic data shown on a policy. Copies of an abstract may be used by the accounting, statistical, payroll audit, and inspection departments.

accident year. The year in which an accident occurred.

account current or agents' account. See **agency billing**.

accretion of discount on bonds. Adjustment of the purchase price of bonds purchased at less than par value to increase the value to par at maturity date. The adjustment is calculated to yield the effective rate of interest at which the purchase was made, which is called the *interest method*.

additional premium. A premium due from an insured arising from an endorsement.

adjustment bureau. An organization formed by a group of insurance entities to investigate, adjust, and negotiate claims on behalf of the entities.

admitted asset. An asset recognized and accepted by state insurance regulatory authorities in determining the financial condition of an insurance entity.

advance premiums. The premiums collected in advance of the premium due dates.

agency billing. Any of various methods of premium billing and collection in which the insured is billed by the agent and the premium is collected by either the agent or the insurance entity.

agency company. An insurance entity whose business is produced through a network of agents, as distinguished from a direct writing entity whose business is produced by entity employees.

agency reinsurance. Reinsurance arranged to be assumed or ceded for an insurer by one of its agents who usually handles the details of writing the policies and collecting or paying the premiums. For example, on very large risks the agent frequently issues only one policy to the insured and then obtains reinsurance from other entities to reduce the exposure of the insurer to a desired level.

agency system. A system of producing business through a network of agents. Such agents have a contract to represent the entity and are of three classes: local, regional, and general. These classes are compensated at differing rates of commission, and general agents have much greater responsibilities and duties than local and regional agents.

agent. An independent contractor who represents one insurance entity, called an *exclusive agent*, or more than one entity, called an *independent agent*, with express authority to act for the entity or entities in dealing with insureds.

agents' balance. Premium balances, less commissions payable thereon, due from agents and brokers.

aggregate excess of loss. A stop-loss agreement designed to prevent a ceding entity's loss from exceeding a predetermined limit. For example, if under an agreement indemnifying an entity against losses in excess of a 70 percent loss ratio, the ceding entity's loss ratio exceeds 70 percent, then recovery will be made from the reinsurer of the amount necessary to reduce the loss ratio to 70 percent.

alien company. Insurance entity domiciled in a foreign country.

amortization of premiums on bonds. Adjustment of the purchase price of bonds purchased at more than par value to decrease the value to par at maturity. The adjustment is calculated to yield the effective rate of interest at which the purchase was made, known as the *interest method.*

annual pro rata. A basis used to calculate unearned premiums involving the assumption that the average date of issue of all policies written during the year is the middle of the year.

annual statement (convention statement or convention form). A statement furnishing the complete information regarding the entity's condition and affairs at December 31 of each year required by insurance departments of the various states in which an entity is authorized to transact business. This annual statement must be filed on the form prescribed by the National Association of Insurance Commissioners (NAIC) with the various insurance departments by March 1 of the following year.

application. A request for insurance submitted to the insurer by or on behalf of the insured. An application usually includes sufficient information for the insurer to determine whether it wishes to accept the risk. In some lines of insurance the terms *daily* and *application* are used synonymously.

assessment enterprise. An insurance entity that sells insurance to groups with similar interests, such as church denominations or professional groups. Some assessment enterprises also sell insurance directly to the general public. If the enterprise cannot pay all claims, the members may be assessed.

assets, ledger. Assets that are recorded in an entity's general ledger. They usually include investments, cash, agents' balances, or uncollected premiums and reinsurance recoverable.

assets, nonadmitted. Assets, or portions thereof, that are not permitted to be reported as admitted assets in the annual and quarterly statements filed with various insurance departments. Nonadmitted assets are either defined by the insurance laws of various states or not specifically identified as admitted assets. Major nonadmitted assets include: agents' balances or uncollected premiums over three months due, certain amounts of deferred tax assets, intangible assets other than goodwill, furniture, fixtures, supplies, and equipment.

assets, nonledger. Assets not recorded on an entity's general ledger. They usually include an excess of statement value of stocks and bonds over their book values and accrued interest or other accrued income on investments.

associations, pools, and syndicates. Organizations formed by several insurance entities or groups of entities as joint ventures to underwrite specialized types of insurance or to write insurance in specialized areas.

audit premiums. Earned premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. Such audits are made and such reports are submitted either monthly, quarterly, semiannually, or annually.

automatic treaty. Reinsurance treaty usually pro rata, under which the reinsurer is committed to accept from the ceding entity a fixed share of each risk or of specified risks. The ceding entity is obligated to cede, and the reinsurer is obligated to accept.

average reserves. A method of estimating loss liabilities by multiplying the number of outstanding claims by an average amount per claim based on past experience.

benefit. Any payment made under the terms of an insurance contract.

binder. An agreement, which may be written or oral, whereby one party agrees to insure another pending receipt of and final action on the application.

bordereau. A detailed listing of premiums or loss transactions, or both, usually prepared monthly or quarterly and given to interested parties. Frequently rendered by ceding entities to reinsurers and by large general agents to entities.

brokers. Licensed representatives who place the insurance of their clients with insurance entities. Compensation for their services consists of commissions paid to them by the insurance entities. They are not agents of the entities, and the commissions they receive are usually lower than that of agents who legally represent the entities.

bulk reinsurance. See **portfolio reinsurance**.

cancellation. Complete termination of an existing policy before expiration.

captive insurance entity (defined in FASB ASC glossary, as presented in the first section of this glossary). Entity formed to insure the risks of an affiliated corporation, typically its parent. Reasons for forming a captive insurance entity include the following:

1. Instances when insurance cannot be purchased from commercial insurance entities for business risk; in many instances, entities within an industry form a joint captive insurance entity for that reason.

2. Premiums paid to a captive insurance entity are deductible as a business expense for tax purposes in certain circumstances. However, sums set aside in a self insurance program are not deductible as a business expense.

3. Insurance can be obtained through the international reinsurance market at a more favorable premium, with higher limits of coverage.

4. Investment returns can be obtained directly on its invested capital. However, competent personnel to manage and staff the entity could be excessively expensive; and further a catastrophic occurrence or series of occurrences could bankrupt the entity.

case basis. Liabilities for losses (claims) or loss expenses determined based on individual estimates of the value of each reported unpaid loss.

case reserve. A liability for loss estimated to be paid in the future on an outstanding claim.

catastrophe. A conflagration, earthquake, windstorm, explosion, or similar event resulting in substantial losses. Catastrophe losses—the whole loss insured by an insurance entity from a single catastrophic event—are usually reinsured under excess-of-loss treaties in order to limit any one such loss to a specific dollar amount.

cession. A unit of insurance passed on to a reinsurer by a ceding or primary entity. Under certain kinds of reinsurance treaties, many reinsurers give each transaction a number, called a *cession number*.

claim adjusting. The process of investigating, appraising, negotiating and, sometimes, settling claims.

claim frequency. The relative incidence of claims in relation to an exposure base.

claim severity. The relative magnitude of the dollar amount of claims.

claim or loss files. All data relating to each loss or claim together in a folder or stapled together, or the like, and referred to as the *loss* or *claim file*.

class or manual rating. A method of determining premiums based on standard rates for large groups of similar risks.

combined ratios. The sum of both the loss ratio and expense ratio used to measure underwriting performance.

commissions. Compensation paid by an insurance entity to agents or brokers for placing insurance coverage with the entity, usually determined as percentages of the premiums.

commutation. A settlement agreement (a buy back) reached between a reinsured and a reinsurer by which the reinsurance obligation is terminated by an agreement by the reinsurer to pay funds at present value that are not yet due under the reinsurance agreement.

contract holder. A person who has an insurance contract in his or her possession or under his or her control. The term is frequently applied to describe the insured, regardless of the ownership of the contract.

contribution to premium in force. Net change in premiums in force for a period or net original premiums written during a period (total original premiums less original return premiums).

convention statement or convention form. See **annual statement**.

daily report or daily. A copy of a policy retained by an insurance entity or forwarded to the entity by an agent. The daily includes all special provisions and endorsements, and it is one of the basic documents in an insurance office.

declaration sets. Documents generated by an insurance entity in processing policy applications and endorsements that include billing statements and insurance ID card, as well as information such as terms of the policies, lines of coverage, premiums, and agent information.

deposit premiums. Provisional premium payments by policyholders that are adjusted at the end of the policy terms based on actual coverage provided.

development (runoff) of loss reserves. Comparison of the loss reserves outstanding at a particular date with the total of the payments on such losses from the reserve date to the development date, plus the estimated losses still unpaid at the date of the development.

differences. Term applied to the differences between accounts current rendered by agents and transactions shown on the entity's records, caused, for example, by the agents and the entity using different cutoff dates or by errors and omissions by the entity or the agents.

direct billing. Billing by an insurance entity directly to insureds for premiums due. On collection, the entity pays the commission to the agent.

direct written premiums. The premiums on all policies an entity has issued during a period of time, as opposed to *earned premiums*. Excludes amounts related to both reinsurance assumed and reinsurance ceded.

direct writing entity. An insurance entity whose business is produced by entity employees, as distinguished from an agency entity whose business is produced by agents.

discounting. Recording future claim payments and expenses at their present value.

domestic insurers. Insurance entities domiciled in a particular state.

earned premiums. Pro rata portions of premiums applicable to the expired period of a policy.

effective date. The date when insurance coverage under a policy begins.

endorsement. Documentary evidence of a change in an existing policy that may result in a change in premium, return premium, or no premium adjustment.

excess insurance. A policy covering the insured against loss in excess of a stated amount. The underlying amount is usually insured by another policy but can be retained by the insured.

excess-of-loss treaty. A kind of reinsurance contract in which the reinsurer pays all or a specified percentage of a loss caused by a particular occurrence or event (frequently of a more or less catastrophic nature) in excess of a fixed amount and up to a stipulated limit. Most such contracts do not apply to specific policies but to aggregate losses incurred under all policies subject to the particular hazards reinsured. The premium is usually a percentage of the net premiums written by the carrier for the hazards subject to such reinsurance.

expense ratio (statutory). Underwriting expenses incurred less other income divided by net written premiums.

experience rating. Prospective adjustment of premiums based on the insured's past experience under the coverage.

exposure. Measurement of the extent of a hazard assumed by the carrier. From the statistical standpoint of rate making, exposure is the product of the amount of insurance at risk and the policy period expressed in years.

face sheet. A sheet affixed to the front of a claim file containing abstracts of coverage and loss notices along with other information for later use in developing statistics for reserve analysis and product pricing.

facultative reinsurance. Arrangements under which each risk to be reinsured is offered to and accepted or rejected by the reinsurer. Such arrangements do not obligate the ceding entity to cede or the reinsurer to accept.

fair access to insurance requirements (FAIR) plan. A federally approved and state supervised program to make property insurance available in high-risk areas.

fellow of the Society of Actuaries (FSA). A full member of the Society of Actuaries. The Society of Actuaries is a professional actuarial society covering North America that maintains rigorous examination requirements for admission to membership.

fidelity bond. Insurance that covers employers against dishonest acts by employees.

fire and allied lines insurance. Property insurance coverage for risks such as fire, windstorm, hail, and water damage.

foreign insurers. Insurance entities domiciled outside a particular state.

funds held by a company under reinsurance treaty. An account used to record a liability from a deposit from a reinsurer or the withholding of a portion of the premiums due as a guarantee that a reinsurer will meet its loss and other obligations.

funds held by or deposited with ceding reinsurers. An asset account used by a reinsurer to record deposits made with ceding entities, pools, or associations of portions of premiums due from them to guarantee that the reinsurer will meet its loss and other obligations.

general agents. Agents assigned exclusive territories in which to produce business on behalf of an insurance entity.

general liability insurance. Liability coverage for most physical and property damages not covered by workers' compensation or automobile liability insurance.

gross in force. Aggregate premiums from all policies on direct and assumed business recorded before a specified date that have not yet expired or been canceled.

gross net premium income. As used in reinsurance contracts, gross written premiums, less return premiums, and reinsurance premiums. This term has the same meaning as *net written premiums* or *net premiums* in the United States. In Europe, the term *net premiums* refers to gross premiums received less return premiums, reinsurance premiums, and commissions paid on premiums.

gross written premium. Direct written premiums plus assumed reinsurance premiums.

hazard. The risk or peril or source of risk insured against. This term is frequently used interchangeably with the terms *risk* and *peril*.

high deductible policy. An insurance policy whereby the policyholder is responsible for the payment of claims under a specified deductible amount. Typically, the insurer pays all losses under the contract and seeks reimbursement from the policyholder for claims paid subject to the deductible amount.

incurred loss ratio. Ratio calculated by dividing incurred losses by earned premiums.

individual or judgment rating. A method of determining premiums for large or unusual risks based on an evaluation of the individual risk.

in-force premiums. Aggregate premiums from all policies recorded before the specified date that have not expired or been canceled.

inland marine insurance. Insurance coverage of property capable of being transported (other than transocean).

installment premiums. Premiums payable periodically rather than in a lump sum at the inception or effective date of the policy.

insurable value. The stated value in an insurance contract. It may be the cash or market value, the declared value, or the replacement value.

insurance expense exhibit. A supplement to the annual statement to be filed with each Insurance Department usually by May 1, rather than on March 1, the day on which the annual statement is due to be filed. The net gain or loss from underwriting for each line of business written by the entity during the year reported on is shown on this exhibit.

Insurance Regulatory Information System (IRIS). A system of 11 tests based on studies of financially troubled entities compared to financially sound entities. Usual ranges are established under each of the tests. The system is intended to assist in identifying entities requiring close surveillance (formerly called *Early Warning System*).

insured. The person whose life, property, or exposure to liability is insured.

interinsurance exchange or reciprocal. An unincorporated aggregation of individuals or firms called *subscribers* who exchange insurance through an attorney-in-fact. Each subscriber is therefore both an insurer and an insured.

intermediary. A reinsurance broker who negotiates reinsurance contracts on behalf of the reinsured (ceding entity) with the reinsurer.

investment expenses. According to the uniform expense regulation, all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income.

judgment rating. See **individual or judgment rating**.

liabilities, ledger. Liabilities recorded in an entity's general ledger.

liabilities, nonledger. Liabilities not recorded in an entity's general ledger but available from other basic records or sources.

line. Kind of insurance. In relation to the amount an insurance entity accepts on a risk: (1) the limit an entity has fixed for itself as maximum exposure on a class of risk and (2) the actual amount the entity has in fact accepted on a single risk.

long-duration contract. An insurance contract that generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

loss (claim)-adjustment expenses. Expenses incurred in the course of investigating and settling claims. Loss-adjustment expenses include any legal and adjusters' fees and the costs of paying claims and all related expenses.

loss ratios. Expression in terms of ratios of the relationship of losses to premiums. Two ratios in common usage are (1) paid loss ratio—paid losses divided by written premiums or earned premiums, and (2) incurred loss ratio—incurred losses divided by earned premiums.

loss reserves. A term used in statutory accounting for the liability for unpaid losses.

losses. Claims.

losses, reported. Losses resulting from accidents or occurrences that have taken place and on which the entity has received notices or reports of loss.

manual rating. See **class or manual rating**.

market conduct examination. A review of an insurance entity's sales, advertising, underwriting, risk-rating, and claims practices that may affect policyholders or claimants. It may be performed by or on behalf of regulatory authorities.

merit rating. Any of various methods of determining premiums by which standard rates are adjusted for evaluation of individual risks or for the insureds' past or current experience.

monthly pro rata. A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during any month is the middle of that month.

mortgage servicing agent. An agent servicing mortgage loans for the mortgagee at a prescribed rate under a contractual agreement.

National Association of Insurance Commissioners (NAIC). An association of the insurance commissioners of all 50 U.S. states and the District of Columbia.

net written premiums. Direct written premiums plus assumed reinsurance premiums less ceded reinsurance premiums.

ocean marine insurance. Coverage for (1) a ship and its equipment, (2) the cargo, (3) the freight paid for use of the ship, and (4) liability to third parties for damages.

original premium. The premium for the full term of a policy. In case the policy has been changed, the original premium can be determined by multiplying the amount currently insured by the latest premium rate shown on the policy or an endorsement of the policy.

paid losses. Disbursements for losses during the period.

participating entity. An insurance entity that participates in an insurance pool, association, or syndicate.

peril. Classification of loss occurrences insured against, such as fire, windstorm, collision, hail, bodily injury, property damage, or loss of profits.

personal lines. Kinds of insurance policies issued to individuals.

policyholder dividends. Payments made or credits extended to the insured by the entity, usually at the end of a policy year, which result in reducing the net insurance cost to the policyholder. Such dividends may be paid in cash to the insureds or applied by the insureds as reductions of the premiums due for the next policy year.

policy year. The year during which a policy is effective.

pooling. Practice of sharing all business of an affiliated group of insurance entities among the members of the group.

portfolio reinsurance. Reinsurance on a bulk basis. Occurs frequently at the inception or termination of a reinsurance treaty. Also used as a means by which an entity may retire from a particular agency or territory or from the insurance business entirely.

premium. The consideration paid for an insurance contract.

premium deficiency. For short-duration contracts, the amount by which anticipated losses, loss-adjustment expenses, policyholder dividends, unamortized acquisition costs, and maintenance expenses exceed unearned premiums.

premium register. Listing of policies issued, generally in policy-number order. Normally computer generated.

premium taxes. Taxes levied at varying rates on insurance entities by the various states on premiums written.

profit commissions. The additional commissions the ceding entity is entitled to receive from the reinsurer based upon experience to date.

proof of loss. A sworn statement furnished by an insured to the carrier setting forth the amount of loss claimed. This form, which is usually used in the settlement of first-party losses, includes the date and description of the occurrence, amount of loss claimed, interested insurers, and so on.

pro rata reinsurance. The reinsured and the reinsurer participate in the premiums and losses on every risk that comes within the scope of the agreement in fixed proportion.

quota-share reinsurance. A form of pro rata reinsurance. A reinsurance of a certain percentage of all the business or certain classes of or parts of the business of the reinsured. For example, an entity may reinsure under a quota-share treaty 50 percent of all of its business or 50 percent of its automobile business.

rating bureau. An organization supervised by state regulatory authorities that assists member entities in obtaining approval for premium rates.

reciprocal or interinsurance exchanges. A group of persons, firms, or corporations (commonly referred to as *subscribers*) that exchange insurance contracts through an attorney-in-fact (an attorney authorized by a person to act in that person's behalf).

reinstatement. A restoration of a lapsed contract to an active status. All contracts contain a provision stating the conditions under which reinstatement will be allowed.

reinsurance assumed premiums. All premiums (less return premiums) arising from policies issued to assume a liability, in whole or in part, of another insurance entity that is already covering the risk with a policy.

reinsurance, authorized. Reinsurance placed with entities authorized to transact business in the state of filing.

reinsurance, unauthorized. Reinsurance placed with entities not authorized to transact business in the state of filing.

reinsurance ceded premiums. All premiums (less return premiums) arising from policies or coverage purchased from another insurance entity for the purpose of transferring a liability, in whole or in part, assumed from direct or reinsurance assumed policies.

reinsurance in force. Aggregate premiums on all reinsurance ceded business recorded before a specified date that have not yet expired or been canceled.

reinsurance intermediaries. Brokers, agents, managing general agents, and similar entities that bring together reinsurance purchasers and sellers.

reported claims. Claims relating to insured events that have occurred and have been reported to the insurer and reinsurer as of the date of the financial statements, as opposed to incurred-but-not-reported (IBNR) claims.

reporting form contract. Insurance contract for which the premium is adjusted after the contract term based on the value of the insured property.

retention. The net amount of any risk an entity does not reinsure but keeps for its own account.

retroactive commissions. Commissions paid to agents or brokers for which the final amount is determined based on the insured's loss experience.

retrocession. A reinsurance of reinsurance assumed. For example, B accepts reinsurance from A, and B in turn reinsures with C the whole or a part of the reinsurance B assumed from A. The reinsurance ceded to C by B is called a *retrocession*.

retrospective experience rating. A method of determining final premium in which the initial premium is adjusted during the period of coverage based on actual experience during that same period.

retrospective premium. Premium determined after expiration of the policy based on the loss experience under the policy. The initial premium charged on such policies is referred to as the *standard premium*.

return premiums. A premium refund due the insured from an endorsement or cancellation.

rider. Endorsement to an insurance contract that modifies clauses and provisions of the contract, either adding, excluding, or limiting coverage.

risk. See **hazard**.

risk-based capital (RBC) requirements. Regulatory and rating agency targeted surplus based on the relationship of statutory surplus, with certain adjustments, to the sum of stated percentages of each element of a specified list of entity risk exposures.

runoff data. See **development (runoff) of loss reserves**.

salvage. The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

schedule rating. A method of determining the premium by which a standard rate is adjusted based on an evaluation of the relative exposure to risk.

short-duration contract. A contract that provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

spread-loss treaty. A contract on an excess-of-loss basis designed to pay certain losses over a given or stipulated amount and to average such losses over a period of years. Five years is the usual period, with the premium adjustable within fixed minimum and maximum limits according to the entity's experience. Such a contract protects the ceding entity against shock losses and spreads those costs over the given period, subject to the maximum and minimum premium each year.

statutory accounting practices. Accounting principles required by statute, regulation, or rule, or permitted by specific approval that an insurance enterprise is required to follow in preparing its annual and quarterly statements for submission to state insurance departments.

statutory loss reserves. The amount by which reserves required by law on bodily injury and workers' compensation losses exceeds the case-basis loss and loss-expense reserves carried by an entity for such losses.

statutory surplus. Admitted assets less liabilities, determined in accordance with statutory accounting practices.

stock companies. Corporations organized for profit to offer insurance against various risks.

stop-loss reinsurance. Kind of excess reinsurance also called *excess-of-loss ratio*. Provides that the insurer will suffer the loss in its entirety until the total amount of the loss is such that the loss ratio (losses divided by, premiums) exceeds an agreed loss ratio, after which the reinsurer reimburses the insurer the amount needed to bring the loss ratio down to the agreed percentage.

structured settlements. Periodic fixed payments to a claimant, for a determinable period of time or for life, for the settlement of a claim, usually funded through the purchase of an annuity.

surety bond. Insurance coverage that provides compensation to a third party for the insured's not performing specified acts within a stated period.

surplus lines. Risks not fitting normal underwriting patterns, involving a degree of risk that is not commensurate with standard rates or that will not be written by standard carriers because of general market conditions. Policies are bound or accepted by carriers not licensed in the jurisdiction where the risk is located, and generally are not subject to regulations governing premium rates or policy language.

surplus share reinsurance. Reinsurance on a pro rata basis of only those risks on which coverage exceeds a stated amount.

surplus treaty reinsurance. A treaty on a pro rata basis reinsuring surplus liability on various risks. The reinsurer shares the gross lines of the ceding entity. The amount reinsured varies according to different classes of risks and the net retention that the ceding entity wishes to retain for its own account. Ceding entities frequently have several layers of surplus treaties so that they may accommodate very large risks; usually, the reinsurer's participation in any one surplus treaty is limited to a certain multiple of the ceding entity's retention. Premiums and losses are shared by the reinsurer and the ceding entity on a pro rata basis in proportion to the amount of risk insured or reinsured by each. This is one of the oldest forms of treaty reinsurance and is still in common use in fire reinsurance.

syndicates. See **associations, pools, and syndicates**.

title insurance enterprise. An enterprise that issues title insurance contracts to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage caused by defects in, liens on, or challenges to their titles on real estate.

treaty. A contract of reinsurance.

treaty-basis reinsurance. The automatic reinsurance of any agreed-on portion of business written as specified in the reinsurance contract.

ultimate-developed-cost method. A method of estimating loss reserves based on a statistical average of the ultimate cost of all claims in a particular line.

underwriting. The process by which an insurance entity determines whether and for what premium it will accept an application for insurance.

unearned premiums. The pro rata portion of the premiums in force applicable to the unexpired period of the policy term.

workers' compensation insurance. Coverage that provides compensation for injuries sustained by employees in their employment.

zone examination. An examination of an insurance entity undertaken by on or behalf of regulatory authorities in a group of states.

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Demotech
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Index

B

D

O

P

Q

R

S

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